In Search of Effective Policies for Foreign Direct Investment: Alternatives to Tax Incentive Policies

Kojo Yelpaala

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In Search of Effective Policies for Foreign Direct Investment: Alternatives to Tax Incentive Policies

Kojo Yelpaala*

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I. INTRODUCTION

It is now largely recognized that the multinational enterprise ("MNE") can play a significant role in the industrialization of a number of different countries. The major way in which the MNE can contribute toward the industrialization of a country is through foreign direct investment ("FDI"). To induce such MNE investment, several host countries

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The commitment of the Reagan Administration to encouraging United States foreign investors to invest in the Caribbean Basin Region was well articulated by President Reagan; see Caribbean Basin Initiative, Address Before the Permanent Council of the Organization of American States ("OAS"), 18 WEEKLY COMP. PRES. DOC. 217 (Feb. 24, 1982). See also Caribbean Basin Initiative Legislation, Statement by the President, 19 WEEKLY COMP. PRES. DOC. 240 (Feb. 16, 1983); Caribbean Basin Initiative, Remarks to Ambassadors of Member Nations of the OAS, 18 WEEKLY COMP. PRES. DOC. 1655 (Dec. 22, 1982). See also H.R. 6715, 97th Cong., 2d Sess., 128 CONG. REC. 3968 (1982)—a bill to amend the Internal Revenue Code of 1954 to allow a credit against income tax for the use of certain forms of business insurance for new business activities in designated Caribbean countries.
have relied significantly on fiscal incentives in general and tax incentives in particular for over half a century.\(^2\) However, after several decades, the effects of these tax incentives on the motivation of MNEs to invest in incentive granting countries continues to be the focus of a heated debate.\(^3\) While some believe that tax incentives do actually motivate MNE investment behavior,\(^4\) others believe that such motivational effects are either


\(^4\) See, e.g., Hartke, *A Foreign Trade and Investment Policy for the 1970s*, in *American Labor and the Multinational Corporation* 54 (D. Kujawa ed. 1973), where he had the following to say about U.S. tax policies:

*Tax Policies—*U.S. tax policies have been designed to encourage the outflow of U.S. capital at the expense of domestic investment. . . .

Our present tax laws create an attractive tax shelter for any income earned abroad by a U.S. corporation. Income earned in the United States is ordinarily taxed in the year when earned. Under our tax laws, however, income earned abroad is never taxed until it is brought home to the States. The unregulated U.S. transnational is in the position of earning capital in the United States, investing that capital overseas, and never paying a dime in U.S. taxes on any income earned abroad.

Even if the profits are brought back to the United States, existing tax law permits the U.S. corporation to take a dollar for dollar credit against domestic federal tax liability for any income taxes paid abroad. The domestic corporation that has chosen to invest in Indiana must pay state taxes and cannot take them as a credit against its federal income tax liability.

*Id.* at 59 (emphasis in original).

See also Goldfinger, *An American Trade Union View of International Trade and Investment*, in *American Labor and the Multinational Corporation*, supra, at 28, where he presents the proposals of the AFL-CIO to include the following:

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negligible or nonexistent.\(^5\) This debate is hardly a trivial matter because whether MNEs are motivated or not by tax incentives has important implications for labor, business, and government policy of home countries.

The current debate over the runaway plant in the United States\(^6\) assumes the efficacy of tax incentives. If on the other hand, tax incentives are not an effective means of attracting FDI, then countries interested in attracting MNE involvement in their local economies need to adopt more appropriate policies. A policy is appropriate for these purposes if it addresses the actual motivational factors in MNE foreign operations. In other words, an appropriate FDI incentive policy is one that is closely tied to or derived from the theory of the MNE. The question, then, is whether current tax incentive policies are appropriate.

For years, tax incentive policies have been based on the capital arbitrage theory of FDI.\(^7\) The capital arbitrage theory, however, is no longer considered an adequate explanation of the FDI process. Consequently, any incentive policies based on this theory are likely to be both misplaced and ineffective. It is the purpose of this article to investigate possible

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The U.S. government must stop helping and subsidizing U.S. companies in setting up and operating foreign subsidiaries.

Taxes on U.S. corporations’ overseas operations are made to more closely relate to the tax rules domestically.

Foreign operations of U.S. firms should carry the same load as their domestic operations. Current U.S. tax provisions encourage movement abroad, even though $15 billion was spent in 1971 by U.S.-based firms in new plant and equipment outside the United States and a host of technology transfers took place. These foreign investments have increased 60 per cent faster than U.S. domestic investments in the past decade.

Id. at 49.


\(^6\) See Goldinger, supra note 4, at 49. For a more recent study of the concerns of American labor unions, see Helfgott, American Unions and Multinational Companies: A Case of Misplaced Emphasis, 18 COLUM. J. WORLD BUS. 81 (1983).

\(^7\) Traditionally, international capital mobility is explained by differential rates of return on capital as between countries. The theory states that capital will move from a capital rich country to a capital scarce country in response to higher rates of return until such rates are equalized. The MNE as an exporter of international capital is in a sense simply an arbitrager of capital. It pursues profits by moving equity capital from countries with low rates of return to countries with high rates of return. Thus, the profits made result from arbitrage activity. This is essentially a portfolio investment theory; it has been used to explain the motivation behind FDI. For a more extensive explanation, see R. CAVES, MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS 31-35 (1982) [hereinafter R. CAVES, MULTNATIONAL ENTERPRISE]. The connection between differential rates of return and differential tax rates as a motivation for FDI has been extensively explored elsewhere by the author. See Yelpaala, The Efficacy of Tax Incentives Within the Framework of the Neoclassical Theory of Foreign Direct Investment: A Legislative Policy Analysis, 19 TEX. INT’L L.J. 365, 371-73 (1984) [hereinafter Yelpaala, Efficacy of Tax Incentives].
alternative incentive policies based on different theories of the FDI process. Specifically, this article will analyze possible alternative and complementary incentive policies under the intangible assets hypothesis,\(^8\) the industrial organization theory,\(^9\) and the internalization theory of FDI.\(^10\)

A. The Need for Reevaluation

The controversy over the MNE and the appropriate home and host country policies has produced an interesting collection of opposing views.\(^11\) Yet, to advocate a shift of focus from the current tax incentive policies and laws to other policies requires some explanation. The utility of tax incentive policies for attracting FDI has been doubted for years. In a recent article this author questioned the theoretical basis of current tax incentives, reviewed various studies on the subject, and concluded that the theoretical basis for current tax incentive policies is flawed.\(^12\) Several reasons were offered for this conclusion. First, incentive granting countries assume either explicitly or implicitly that there is some causal relationship between differential tax rates and FDI. Several existing policies appear to have been induced by deductive logic from the neoclassical international trade theory which inspired the capital arbitrage theory of FDI.\(^13\) This theory established a spurious causal link between differential rates of return, differential tax rates, and the FDI process.\(^14\) Second, incentive granting countries assume that all FDI investors have a short-term profit motive which can be induced by tax rate reductions. Third, there is an assumption that the MNE parent and its units for foreign operations would independently seek to maximize profits and deal with each other at market prices.\(^15\) This article will demonstrate that these assumptions cannot easily be supported by our knowledge of the characteristic attributes and distinctive behavior of the MNE. Fourth, even if tax incentives would motivate FDI activities, the existence of competitive tax concessions given by host countries would tend to undermine their effectiveness.\(^16\) Fifth, tax incentives might not only be ineffective but

\(^8\) See infra notes 55-97 and accompanying text.
\(^9\) See infra notes 98-157 and accompanying text.
\(^10\) See infra notes 158-86 and accompanying text.
\(^11\) See infra note 26.
\(^12\) See Yelpaala, Efficacy of Tax Incentives, supra note 7, at 413.
\(^13\) Id. at 373.
\(^14\) Id. at 379.
\(^16\) See Stewart, supra note 5, at 156.
might also induce a reverse subsidy to capital-rich developed countries.\(^{17}\)

Sixth, several studies have stressed that tax incentives have been disregarded by MNEs because these incentives tend to be plagued by bureaucratic uncertainties. Finally, tax incentives are inefficient and costly.\(^{18}\)

Notwithstanding these problems with tax incentives, several countries have continued to rely on the capital arbitrage theory of FDI as the basis for FDI inducement policies. Indeed, there has been, in very recent times, a proliferation of very liberal revisions of tax incentive laws by several host developing countries.\(^{19}\) Determined to maintain their industrialization drive, newly-industrialized countries such as South Korea and Taiwan have engaged in competitive liberal tax policies directed at MNEs.\(^{20}\) In addition, middle- and low-income countries faced with the growing need for technology transfer, capital, and managerial expertise for industrial expansion, manufactured exports, and mineral extraction, find themselves in strong competition for FDI with the more economically successful industrialized countries. As a result, they have also found it necessary to further liberalize their tax incentives.\(^{21}\) In a remarkable reversal of economic policies, even the People's Republic of China has hopped on the bandwagon of countries seeking foreign capital and MNE involvement through tax incentives.\(^{22}\) The theoretical basis

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\(^{17}\) See Yelpaala, Efficacy of Tax Incentives, supra note 7, at 388.

\(^{18}\) See G. Reuber, supra note 1.

\(^{19}\) The United Nations Centre on Transnational Corporations has, for years, been collecting legislation affecting foreign investment in several countries. Such legislation includes incentive legislation for attracting foreign investment. The list of countries includes several developing countries. See UNCTC, National Legislation, supra note 2.


\(^{21}\) UNCTC, National Legislation, supra note 2, at 29-39.

for their incentives continues to be the capital arbitrage theory.

Reliance on tax incentives by developing countries as instruments for attracting FDI continues to be baffling in the face of the known patterns of behavior of the MNE. Despite their sometimes liberal tax incentive packages, developing countries have been the least attractive to MNEs.\textsuperscript{23} FDI tends to originate from a few developed market economies and go to a few developed countries.\textsuperscript{24} Current statistics show that MNEs tend to locate their foreign operations in the richer of the richest and the richer of the poorest countries of the world.\textsuperscript{25}

These patterns or preferences suggest that MNEs are attracted to countries with the greatest economic potential or with affluent markets. They also suggest that the tax burdens in these markets have not been a significant deterrent to investments. They further suggest that, left alone, MNEs will continue to locate their plants in countries with the highest economic potential. The implication is that developing countries will continue to be the least attractive to MNEs unless something is done to reverse the pattern.

If MNEs are to play a significant role in the impending structural transformation of the 1980s, home and host countries must develop appropriate FDI policies which reflect the theory of the MNE. Since the capital arbitrage theory and its connection to tax incentives has proven to be dubious at best and ineffective at worst, it is important at this stage to investigate the possibility of more effective FDI incentive policies based on other theories of the MNE. Therefore, the focus of this article is on the incentive policy possibilities of other theories of the FDI process.

\section*{II. THE MNE SYSTEM AND INCENTIVES}

One significant problem of policymakers is their apparent lack of complete understanding of the MNE phenomenon. From its inception, the MNE has been the subject of intensive study and controversy.\textsuperscript{26} As

\begin{itemize}
  \item \textsuperscript{24} UNCTC, \textit{Salient Features}, supra note 23; UNCTC, Third Survey, supra note 1, at 27.
  \item \textsuperscript{25} See generally UNCTC, Third Survey, supra note 1, at 34-35. See also OECD, \textit{International Investment and Multinational Enterprise: Recent International Direct Investment Trends} (1981) [hereinafter OECD, \textit{International Investment}].
  \item \textsuperscript{26} The literature on the MNE is so voluminous that it would be impossible to provide a complete list here. It will be sufficient to list material representing various viewpoints in the debate. See, e.g., L. Turner, \textit{Multinational Companies and the Third World} (1975); N. Girvan, \textit{Corporate Imperialism: Conflict and Expropriation} (1976); Global Companies: The Polit-
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such, the MNE should be a well-known entity to policymakers. Nonetheless, the MNE is an economic phenomenon that appears to defy definition. Although several definitions have been suggested, the most useful definition is one which links the MNE with its characteristic attributes and distinctive behavior.

The MNE is best understood as a system. It is functionally an international system that owns or commands globally vast amounts of technological, financial, managerial, human, or marketing resources. The MNE represents a network of operations, services, or a global multiplant system connected through a common resource pool and a common strategy with all its component parts. The structure is controlled by a monocentric or polycentric management command system. As such, the MNE enjoys tremendous flexibility in its operational decision process. Its decisions are neither bound nor seriously limited by considerations of distance, time, space, or by regional, national, or cultural allegiances. Though considerations of plant location, marketing, import, or export operations might fall to the dictates of the management control system, such considerations are designed to enhance the flexibility of the multinational system.

MNEs differ in size, technical capabilities, and degree of product


27 The Multinational Enterprise as a phenomenon has been characterized by definitional problems from its inception. Some definitions stress multinationality, geographic dispersion, and management orientation, while others stress control. The following are examples of the attempts at defining the MNE. See generally UNITED NATIONS DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, MULTINATIONAL CORPORATIONS IN WORLD DEVELOPMENT 5 (1974). Some definitions emphasize several different criteria. For instance, for criteria such as: 1) organizational structure and ownership, see Aharoni, On the Definition of a Multinational Corporation, in THE MULTINATIONAL ENTERPRISE IN TRANSITION 4-5 (A. Kapoor & P. Grub eds. 1972); 2) the number of countries in which operations are carried on, see Dunning, The Multinational Enterprise: The Background, in THE MULTINATIONAL ENTERPRISE 15, 16 (J. Dunning ed. 1971); 3) size of total operations, see R. VERNON, SOVEREIGNTY AT BAY, supra note 22, at 4 (1971); 4) attitude of management (ethnocentric, polycentric or geocentric), see Perlmutter, The Torious Evolution of the Multinational Corporation, in THE MULTINATIONAL ENTERPRISE IN TRANSITION, supra, at 53; Ball, Cosmo Corp: The Importance of Being Stateless, in WORLD BUSINESS 337 (C. Brown ed. 1970).

28 See Yelpala, Impact of Industrial Legislation, supra note 16.
and geographic diversification. For example, MNEs range from the world's largest grocery products company, Unilever, with operations in seventy-five countries and sales in 1980 of $24 billion, to Wrigley Chewing Gum Company, with a sales of $500 million. It has been estimated that there are today about 10,000 MNEs with a total of about 100,000 subsidiaries. Most of these MNEs are small and have operations in two or three countries. Nonetheless, the MNEs that are responsible for a substantial portion of FDI are the largest 500 companies in the world. Each of the MNEs, small or large, constitutes a separate system varying in size, complexity, and flexibility depending upon its total available resources and the number of countries in which it operates. Hence, the impact of any policy designed for the MNE would vary depending upon the MNE's degree of flexibility.

This flexibility is inherent in the MNE control and management command system and permits the MNE to manipulate its global operations in response to various economic stimuli, costs, government attitude, and geo-political considerations. Thus, the same MNE, through the establishment of foreign subsidiaries or global affiliates, may extract raw material in one country, to be manufactured as semi-finished products in a second country, to be used in the manufacture of a finished product in a third country, to be marketed in yet a fourth country. Therefore, through this system of linkages between parent MNE and its foreign affiliates and between the affiliates themselves, the MNE is afforded the opportunity to use each affiliate as a conduit for shuttling resources from one country to another or to shift profits from high-tax regimes to low-

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30 Id.
31 Id. at 2.
33 The inherent flexibility in the MNE and its global system was vividly described by Newfarmer and Mueller in an interesting report to the U.S. Congress in 1975: see R. NEWFARMER & W. MUELLER, MULTINATIONAL CORPORATIONS IN BRAZIL AND MEXICO: STRUCTURAL SOURCES OF ECONOMIC AND NONECONOMIC POWER, REPORT TO THE SUBCOMM. ON MULTINATIONAL CORPORATIONS OF THE SENATE COMM. ON FOREIGN RELATIONS, 94th Cong., 1st Sess. 14 (Comm. Print 1975).
tax regimes according to the dictates of the management command system.

An important aspect of the MNE system is the degree of isolation between MNEs. Each MNE system constitutes a separate system, suggesting that an important industry in a country might be fragmented along oligopolistic lines thereby resulting in certain allocative inefficiencies and the loss of control by the host government. This is illustrated by the experience of Ghana in dealing with some of the largest MNEs in the aluminum industry. These MNEs operate as isolated units, with most of their linkages created within their own systems. Accordingly, the aluminum industry in Ghana is fragmented and so are its connections with the rest of the global aluminum industry. As a result, Ghana exports bauxite, imports alumina, exports primary aluminum, and imports rolled aluminum to be fabricated into aluminum products.\(^3\)

One may characterize the typical large MNE as potentially "foot loose"\(^3\) or as an acquisitive and gigantic octopus, its tentacles sprawling all over the globe. This analogy is borne out by the high degree of MNE concentration by country of origin, industry, growth, diversification, and internal operational dynamics. The bulk of the FDI in the world comes from a very small number of industrialized countries. Only six such countries—United States, United Kingdom, Germany, Japan, Switzerland, and France—account for more than eighty percent of the total global stock of FDI.\(^3\) From this small number of countries, the MNE system spreads out globally. In 1976 there were about 11,000 companies that operated 82,600 foreign affiliates worldwide.\(^3\) Out of this total, about 371 MNEs operated in at least twenty or more countries.\(^3\)

For some of the world's largest MNEs, the geographic diversification of their operations is even more outstanding. In 1973, it was estimated that IBM operated in as many as eighty countries, while Siemens and ITT operated in fifty-two and forty countries, respectively.\(^3\) The corresponding figures for MNEs in the oil industry are equally impressive. Mobil, Gulf, and Shell operated in sixty-two, sixty-one, and forty-three countries, respectively.\(^3\) These foreign operations have always

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\(^3\) D. Hart, The Volta River Project 59 (1980).
\(^3\) OECD, Investing, supra note 23, at 20.
\(^3\) Id.
\(^3\) P. Buckley & M. Casson, supra note 35, at 12-13.
\(^3\) Id.
been very important in MNE total operations.\textsuperscript{41} For example, in 1977 the sale of the foreign affiliates of 866 of the world’s largest industrial enterprises accounted for twenty-seven percent of their total sales volume.\textsuperscript{42} The foreign content ratio of these enterprises in manufacturing, as calculated by John Dunning and Robert Pearce, was also quite substantial.\textsuperscript{43}

The relationship between these foreign affiliates and their parent MNEs is not one of isolated and independent existence. They are linked together through the necessity of horizontal and vertical diversification, common resource pool, common international marketing and distribution strategy, common technological needs, and management control.\textsuperscript{44} These connections are certainly obvious in the manufacturing industry where the incidence of horizontal diversification has been adequately documented.\textsuperscript{45} Subsidiaries of MNE trading companies, such as the Japanese trading houses, have always needed their parents for access to world markets.\textsuperscript{46} Evidence of vertical diversification can be found in the frequency and size of intra-firm transactions between MNEs and their subsidiaries. Though the statistics and data on these transactions are still incomplete, the information which does exist suggests that the size of intra-firm transactions within the MNE system is fairly significant. For instance, in 1974, forty-six percent of all imports to the United States were intra-firm.\textsuperscript{47} It is also estimated that roughly fifty percent of the exports from the United States in 1970 and thirty-nine percent of Canadian exports in 1971 were all within the MNE system.\textsuperscript{48}

In 1977, United States MNEs accounted for about eighty-four percent and fifty-eight percent of the value of United States exports and imports, respectively.\textsuperscript{49} Intra-MNE imports accounted for forty-eight percent of the total value.\textsuperscript{50} These MNEs have shown a strong preference for intra-firm transactions with higher degrees of processing. Moreover, MNEs no longer consider locating their production facilities near their markets as important. Large MNEs in the automobile and elec-

\begin{thebibliography}{1}
\bibitem{41} J. Dunning, \textit{Int’l Prod.}, \textit{supra} note 37, at 3.
\bibitem{42} Id. \textit{See also} UNCTC, \textit{Third Survey}, \textit{supra} note 1, at 18.
\bibitem{44} R. Vernon, \textit{Storm}, \textit{supra} note 1, at 19-37. \textit{See also} P. Buckley & M. Casson, \textit{supra} note 35, at 20.
\bibitem{45} P. Buckley & M. Casson, \textit{supra} note 35.
\bibitem{46} T. Ozawa, \textit{Multinationalism, Japanese Style} 45 (1979).
\bibitem{47} UNCTC, \textit{Third Survey}, \textit{supra} note 1, at 161.
\bibitem{48} Id.
\bibitem{49} I. Connor, \textit{supra} note 29, at 13.
\bibitem{50} Id.
\end{thebibliography}
tronics industries, for example, now prefer to set up networks of integrated production units located in different countries but all involved in the processing of different stages or parts of the final product. Such production is generally required to serve the needs of the parent or other members of the group in third countries. A significant amount of MNE investments in certain cheap labor havens such as Taiwan and South Korea are of this character. Bruce Kogut has suggested that the dynamism and flexibility of the MNE system constitutes its primary advantage because it provides several options to the MNE. Viewed in this way, the MNE system has operational value to its managers since it increases and links together options and opportunities which otherwise would have been less attractive.

It is clear from this analysis that the MNE is a very complex phenomenon which, in several cases, has developed a global mind set. The MNE views its own national economy as too limited for its potential in production, sales, and resource utilization. This global orientation, coupled with the existence of foreign affiliates, means the MNE can expand its economic space at will. If this is the type of entity that current tax incentive legislation is addressing, then serious questions are raised about the appropriateness of any policy that does not focus on these attributes of the MNE. Given the tremendous flexibility in the behavior of the MNE, one must ask: what types of policies would induce MNE investment and where would its operational effects be felt? Since the MNE can structure its manufacturing and distribution system by choosing the countries with policies which suit it best, the MNE system may purposely burden some countries with negative externalities and bless others with substantial welfare benefits.

The operations of the MNE can affect any or all of the nations included in this system at both the micro- and macro-economic levels in terms of contributions to gross national product, prices, profitability, and national revenue. For those countries linked together by this process, the ability of each to benefit from MNE operations will not be a simple function of any monolithic tax incentive legislation, but how each country by design fits into the MNE system. Can incentive legislation which does not recognize the inherent flexibility of MNE behavior effectively induce FDI?

51 OECD, INTERNATIONAL INVESTMENT, supra note 25, at 31.
52 Yelpala, Impact of Industrial Legislation, supra note 20.
53 Kogut, Foreign Direct Investment as a Sequential Process, in THE MULTINATIONAL CORPORATION IN THE 1980s, supra note 1, at 38, 42-43.
54 Id. at 46-47.
Thus the question of what are the appropriate policies for attracting FDI requires at least a thorough understanding of the MNE system. In addition, such policies should be based on those theories of the MNE that most closely reflect the MNE system and its distinctive behavior. The task of the following sections is to explore, within the context of the MNE, those policy options which appear to incorporate some of the MNE’s characteristics.

III. INTANGIBLE ASSETS THEORY OF FDI

A useful place to start an exploration of alternative incentive policies is the intangible assets theory. Critics of the capital arbitrage theory argue that central to the MNE’s motivation to engage in foreign operations is the possession of some proprietary knowledge or intangible assets.\(^{55}\) (As used here, the two terms are interchangeable.) This theory holds that the most successful firms in any industry possess, in some form, intangible assets to the exclusion of others. The nature or character of these intangible assets may take different forms. They may represent technology, knowledge of cost-minimizing productive efficiency, patented processes, registered trademarks, designs, or brand names. They may even rest on production or trade secrets known to and shared by the employees of a particular firm or skills in styling or promoting products.\(^{56}\) What all these intangible assets have in common is that they are thought of as having the character of a “public good” in the sense that they can be exploited over and over by several different firms without depleting their usefulness.\(^{57}\) According to Harry Johnson, the acquisition of such assets involves some initial investment outlays, but once the knowledge or intangible asset is acquired, the investment costs are considered sunk costs.\(^ {58}\) After these developmental costs, the marginal cost of exploiting such an asset abroad is practically nil for the MNE. The marginal cost of such assets is lower than that of the local firm or other firms that do not own similar intangible assets. Thus, according to this theory, the local firm and others which do not own intangible assets are at a competitive disadvantage with MNEs in the same industry.


\(^{56}\) R. CAVES, MULTINATIONAL ENTERPRISE, supra note 7, at 3-4.

\(^{57}\) Johnson, supra note 55, at 36.

\(^{58}\) Id.
The possession of intangible assets or similar proprietary knowledge alone cannot explain the MNE motivation for FDI because MNEs have other alternatives to FDI. They may choose to service foreign markets through exports from their production at home. They may even grant an assignment or license of their know-how or technology to a local producer. The choice to engage in foreign operations, therefore, must have some additional advantage: it must offer the highest return in comparison with the other alternatives. For instance, the direct exports option might be saddled with heavy transportation costs, excessive customs duties, high tariff and nontariff barriers, thereby making the product uncompetitive at prevailing market prices in the importing country. Similarly, several obstacles to licensing may exist. The host government may control and supervise licensing agreements in terms of their substantive content or royalties agreed upon by the parties. Moreover, the local licensee may be both unwilling and unable to pay the appropriate rent. Under either of these circumstances the owner of the intangible assets cannot reap the desired maximum returns.

Two general explanations for FDI are offered by the intangible assets theory. First, MNEs engage in foreign operations because of the problems of market imperfections associated with arms-length contractual transactions. Second, MNEs engage in foreign operations for cost reasons. MNEs have firm-specific revenue-producing assets which cannot be employed efficiently from their home base because of information, communication, and transportation costs associated with the distance. To understand fully the intangible assets theory, it is necessary to examine these two explanations in greater detail.

A. Market Imperfections and FDI

According to the market imperfection hypothesis, MNEs with intangible assets cannot sell or license them efficiently in conventional markets because of certain factors related to the assets' infirmities. First, since intangible assets are treated as "public goods" from the point of view of resource allocative efficiency, the rental price of such intangible assets should be close to zero. While such a societal goal might be most

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59 See R. CAVES, supra note 7, at 3-4; Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937); S. HYMER, THE INTERNATIONAL OPERATIONS OF NATIONAL FIRMS: A STUDY OF DIRECT FOREIGN INVESTMENT 48 (1976); Johnson, supra note 55, at 37; P. BUCKLEY & M. CASSON, supra note 35, at 22-23.


61 Id. at 259.

62 Johnson, supra note 55, at 41.
acceptable to the renters of technology, it is not in the interests of profit-
maximizing MNE owners of technology. This situation is further com-
plicated by the perceptions and realities of technology transfer. For ex-
ample, what is the appropriate rental price of obsolete technology to a 
licensee in a developing country? Should the rental price be controlled 
by its market value in the home market, in which it is obsolete, or in the 
host country? It appears equally difficult to determine the rental price of 
frontline technology when the foreign licensee has been induced into 
questioning the claimed value of technology in general. Under these 
circumstances the intangible assets theory suggests that MNEs would prefer 
to invest in the use of their technology abroad.

In any arms-length transaction for technology, there are likely to be 
several problems related to uncertainty in the terms and distrust among 
the parties. For example, the seller must prove the quality, operational 
capabilities, and value of the technology, but disclose only as much as is 
necessary to strike a deal. The buyer may suspect the seller of opportu-
nism and overstating the value. There might also be problems relating to 
disparities in bargaining power. In view of these contract law related 
problems, profit-maximizing MNE owners of technology would prefer to 
invest in their use abroad.63

While these arguments appear relevant to horizontal FDI, they may 
be equally applicable to vertical investments.64 MNEs relying on foreign 
suppliers for primary factor inputs have to work the spot and futures 
markets efficiently or develop long-term stable contractual relationships 
with their suppliers. However, both of these markets, either in the short 
or long run, are riddled with costly and significant contract and perform-
ance uncertainties.65 Without control over the production and transporta-
tion, MNEs would face uncertainties in the levels of output, delivery 
dates, and prices over time. Consequently, firms seek to own or control 
vertically their sources of primary or intermediate factor inputs through 
FDI.

B. Cost Factors in FDI

The relationship between costs and FDI in the use of intangible as-
sets was developed most elaborately by Seev Hirsch.66 According to 
Hirsch, given the possession of some intangible assets ("K"), the ques-
tion whether a profit-maximizing firm will service its foreign markets

63 R. CAVES, supra note 7, at 4-6.
64 Id. at 16.
66 Hirsch, supra note 60, at 260.
through exports or engage in foreign operations is determined by cost factors.67

First, the firm will be concerned with the production costs in both the host ("Pb") and home ("Pa") countries. Second, there are costs associated with controlling foreign operations ("C") from the home base. Some of these costs relate to the internal structures, dynamics, management, and coordination of decentralized global production operations. Other cost items relate to the host country's environment, such as its tax system, labor codes, and other regulatory institutions and machinery. Finally, the firm must face the export marketing cost differential ("M") which is the positive difference between export and domestic marketing costs.68 The former exceeds the latter because it is always more costly to export than to produce and sell within the host country.

Given these cost items, Hirsch concluded that FDI will take place under the following conditions:

1. Pb + C < Pb + K
2. Pb + C < Pa + M.69

Since Pb is the same on both sides of Equation 1, that equation merely states that FDI will take place when there are net positive returns on the use of intangible assets in the host country, taking into account all the costs associated with controlling foreign operations. In comparison, Equation 2 takes into consideration comparative total costs. In other words, FDI will take place if the cost of production plus the cost of controlling foreign operations in the host country is less than the alternative—the total of the costs of production and the export marketing cost differential.

The intangible assets hypothesis has some empirical support. The boom in United States MNEs and their foreign operations, particularly after the Second World War, is said to have been closely associated with their adjustments to technological possibilities.70 In fact, this relationship dates back to the period before the First World War. In a historical analysis of United States MNEs, Mira Wilkins found that, even in the early days of the MNE, superiority in knowledge was very important in the FDI process.71 Superior know-how explains the FDI operations of such firms as Singer and American Radiator. A wide variety of empiri-

67 Id.
68 Id. at 261.
69 Id. at 264.
cal studies conducted to test the validity of the intangible assets theory tend to show that the theory explains the foreign investment behavior of several United States MNEs in the manufacturing industry. Several studies by economists such as William Gruber, Dileep Mehta, Raymond Vernon, Thomas Horst, Thomas Pugel, and Sanjaya Lall all found a positive link between research and development ("R & D") outlays and FDI. Others found a significant relationship between managerial skills and talent and FDI. This theory has also found empirical support in the investment behavior of United States firms involved in the extractive industries, banking, and other service industries.

C. Intangible Assets—Incentive Policy Implications

An analysis of the policy implications of this theory requires some understanding of its basic underlying assumptions. The intangible assets theory assumes implicitly that all intangible assets constitute legally-protectible property with universally-recognized attributes. It assumes the existence of an international legal regime and a uniform set of national rules adequately protecting the property interest in these assets, including the grant of monopoly or semi-monopoly rights to owners of industrial property limited in time to the period of protection. As a technology owner, the MNE is one of the most powerful phenomena in the capitalist system; nonetheless it insists on these protections at home and abroad against new entrants, imitators, and industrial pirates. This protection becomes an economic imperative if the MNE is to maintain its industrial characteristics and reap monopoly profits on the use of its technology abroad.

Thus, at the international level, adequate legal protection requires some participation by host countries in various multilateral, bilateral, or regional conventions and treaties which recognize and protect industrial property rights similar to those enjoyed in the home country. Despite

72 Gruber, Mehta & Vernon, supra note 55.
75 Lall, Monopolistic Advantages and Foreign Involvement by U.S. Manufacturing Industry, 32 OXFORD ECON. PAPERS 102 (1980) [hereinafter Lall, Monopolistic Advantages].
77 T. PUGEL, supra note 74, at 18-19.
78 R. CAVES, supra note 7, at 11.
the current controversy, the Paris Convention of 1883 is an example of a multilateral system of industrial property protection to which several developed and developing countries have subscribed.\textsuperscript{79} There appears to be little or no conceptual difficulty with the recognition of industrial property. The problem lies with the nature and extent of protection.\textsuperscript{80} Therefore, some regional groups have sought to harmonize their treatment of industrial property in the FDI process.\textsuperscript{81} At the national level, adequate protection for technology owners would include not just statutes protecting patents, trademarks, and know-how, but effective judicial systems to stop infringers and provide remedies.

Given these implicit assumptions about the legal regimes of host countries, the theory postulates the conditions for FDI to take place. MNEs, the theory states, are very sensitive to instability and uncertainty in their technology transfer and supply contracts. Licensing contracts are fraught with many uncertainties relating to royalties or fees and other factors. Long-term raw material or intermediate supply contracts are similarly fraught with uncertainties relating to the vagaries of price fluctuations, quality, non-performance, and the inability to meet delivery dates. To bypass these contract-related problems, MNEs engage in horizontal and vertical FDI so that they can control the manufacturing process using their own technology or maintain complete control over their supply lines.

If these assumptions are true, then this theory has implications for countries that possess exploitable natural resources or are interested in expanding their manufacturing industries. Several developing countries are heavily dependent on their primary resources for their economic survival. The policies of these countries have often also stressed the need for manufactured export expansion or import substitution. Countries relying on such policies hope that they will have some positive effects on employment, balance of payments, and intersectoral linkages. The theory, therefore, opens up certain policy possibilities if the host countries' objectives can be achieved.

1. Market Imperfections and Incentive Policies

It should be noted that the contract-related market imperfections


\textsuperscript{81} W. White & B. Ravenscroft, \textit{Patents Throughout the World} 571 (1982).
described above do not immediately suggest any tax policy instruments as a means of inducing FDI. They are not the type of factors which generally concern tax policymakers. Moreover, if these market imperfections exist, then MNEs have the necessary conditions for FDI. Therefore, these imperfections should not be removed if the host country wishes to entice FDI. If, on the other hand, the market imperfections do not exist, the question is whether the host country should create them to attract FDI.

The experience of several host countries tends to show that these imperfections already exist. The practice of several host countries of intervening in contractual transactions between MNEs and local licensees is not to create distortions within the markets, but to correct certain actual or perceived distortions, inequities, and negative effects of technology transfer transactions not addressed by the theory. For instance, the theory does not question the appropriateness of the technology transferred nor its price and general impact on the national economy. It is the belief of several developing countries that the technology transferred by MNEs is generally more capital intensive than their needs, exploitative in price, restrictive in use, and marginal in its developmental impact on the local economy. Moreover, the relationship between local licensees and MNE technology owners is characterized as being unequal in terms of bargaining power. Large MNEs, in particular, are perceived as having excessive bargaining power—because of their oligopolistic position in these markets and their monopoly rights in technology—with which they can exploit local licensees.

Countries such as Brazil, Mexico, and South Korea have all intervened in various ways to control licensing fees, royalties for patents, and trademarks transactions. Others have sought to control the type and

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83 Rosenn, Regulation of Foreign Investment in Brazil: A Critical Analysis, 15 LAW. AM. 307, 321-25 (1983); see also sources cited supra note 82.
conditions for the transfer of technology. Two possible conclusions can be drawn. First, that host governments seek to intervene in these markets implies that the necessary conditions for FDI under this theory exist. Second, even if the conditions do not exist, the present form of government market intervention would create them. Therefore, in the limited case of government policy implications, host governments need not do anything more to attract FDI.

The intangible assets hypothesis also seems to suggest that imperfections in the information markets for technology arise from the malfunctioning of the markets rather than government intervention. This is not the appropriate place to enter into the current debate over normative- and ideologically-oriented concepts about the proper relationships between the regulatory functions of a legal system and economic efficiency as a national objective. Nevertheless, it is important to question whether, on the basis of allocative or distributive efficiency, a government should purposefully create economic distortions or increase them as a stimulus to foreign investment. This is even more important given that the entities to be enticed are MNEs with a tremendous ability to exploit their environment. The real issue is, therefore, whether these market imperfections are necessary for FDI or whether they actually permit MNEs to reap monopoly rents in the use of their technology abroad. If reaping monopoly rents is the issue—as the MNE system might suggest—then a policy designed to correct market imperfections might encourage the appropriate FDI up to an optimal level by eliminating the opportunity for monopoly rents.

Johnson has suggested that it is possible to have an optimal national policy under this theory. Since intangible assets have the character of "public goods," optimality requires that they be acquired by the host government through a lump-sum payment and be made available to all potential users, both foreign and domestic, without charge. This suggestion does not eliminate the contract problems inherent in these assets. Nor does it eliminate the fear and reluctance of MNEs to provide host governments with the technological ammunition that might be used against them by the MNE's competitors. The suggestion, however, will

84 There has, in recent years, been a debate on the issue of efficiency and national economic policy goals. See Symposium on Efficiency as a Legal Concern, 8 Hofstra L. Rev. 485 (1980), where contributions of some of the most prominent authorities can be found. See, e.g., Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, supra, at 487; Calabresi, An Exchange About Law and Economics: A Letter to Ronald Dworkin, supra, at 553; and Dworkin, Why Efficiency?, supra, at 563. See also A Response to the Efficiency Symposium, 8 Hofstra L. Rev. 811 (1980).

85 Johnson, supra note 55.
provide a subsidy to all enterprises using that technology. For the MNE that originally owned the technology, the subsidy could prove to be quite important, since the MNE would use and control internally technology for which it has already paid. If allowed to create and operate its system freely, the MNE could generate and maintain its operational options and flexibility with assets provided by the host government. However, the benefits to the host country are unclear. It is therefore doubtful whether Johnson’s pareto-optimality solution has any practical utility in the current international economic scene. The importance of Johnson’s suggestion highlights the need for government involvement.

The policy implications here are complex. What, for example, explains the fact that Liberia, unlike Brazil, South Korea, or Mexico, is not interventionist in technology transfer transactions, and yet attracts very little manufacturing or total FDI? Moreover, several developed market economies which espouse the philosophy of laissez faire, such as Liberia, have attracted most of the world’s FDI. Therefore, the theory must assume that profitable opportunities exist for it to work because the difference between Liberia and these other countries is that Liberia is not as attractive to MNEs in several sectors.

What has emerged from this discussion of the policy options is that host countries should not do anything more to attract the infusion of foreign technology through FDI. However, from our understanding of the MNE, particularly its operational flexibility, host countries cannot afford a “hands-off” policy towards FDI and the technology package that comes with it. Left alone, the MNE will determine the role each country should play within its operational network and the technology package facilitating that role. By transferring technology within its system, the MNE may achieve several objectives inimical to the interest of the host country. The technology transfer transaction may reflect the MNE’s cost allocation, profit sharing, or pricing policies which may have nothing to do with the marketplace or efficiency goals of the host government. The parent MNE may carry out its global market allocation policies by imposing various restrictive business practices on its subsidiaries. These restrictions may include those on output volume, exports, research and development, and others generally condemned by several countries.

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87 Id.
88 See Ariga, Restrictive Business Practices and International Controls on Transfer of Technology,
It follows that, even if the conditions for FDI exist, host countries have very important reasons to ensure that the technology which enters the MNE system through its local subsidiaries advances certain specific host country objectives. It is also important that such technology is free from all encumbrances and restrictions detrimental to the host country’s interest and industrial policies. In this process, the host country cannot afford to play a passive role if specific technology transfer policy objectives are to be met. The host country should determine how the MNE system fits into the country’s economic goals before determining appropriate technology policies. For instance, suppose a host country is determined to develop and become internationally competitive in a complex industry such as the chemical industry. What would be the appropriate technique? By its very nature, the chemical industry should require a fairly complex and capital-intensive technology. To ensure competitive product quality, frontline technology and a very efficient skilled labor force may be required. What then would be the most appropriate host country policies for encouraging investments in the chemical industry? First, the host country could subsidize the desired specific technology either directly or indirectly. It could subsidize the cost of such technology or offer guarantees of specific rental rates as between the parent and subsidiary. It could also subsidize the training of skilled technicians essential for such technology. For a host country which is determined to develop local technical expertise, its labor policies for FDI provide an opportunity to examine policy options for achieving those objectives and encouraging FDI.

In contrast, if the host government is interested in encouraging adaptation and R & D, it may encourage the transfer of technology that would easily lend itself to adaptation and modification. Such technology need not be frontline technology. For the benefits of adaptation to be realized, the policy may include initially some local participation and eventually a fade-out period by the foreign investors. The host govern-

ment would then be required to subsidize the cost of adaptation, R & D, and activities designed to foster its policy objectives. This approach calls for an active and purposeful host country involvement in FDI technological input. It also calls for a re-examination of the concept of appropriate technology. The appropriateness of technology should not be determined solely by a country’s level of development, but also by its potenti-alities and specific government industrial policies. The experience of Japan and the newly-industrializing countries suggest that a well-calculated policy, even if against conventional wisdom, might be more beneficial to host countries. Therefore, given any host country’s industrial policy objectives, specific policies can be adopted to encourage the appropriate technology.

2. Cost and Incentive Policies

It is also possible to develop other incentive policy options under this theory. They would appear to come under Hirsch’s conditions for FDI discussed above. According to Seev Hirsch’s theory, FDI will take place if either of the following inequality conditions exist: (1) $Pb + C < Pb + K$; (2) $Pb + C < Pa + M$. In other words, in comparison with serving foreign markets with exports, the use of intangible assets in FDI should yield a net positive return. In dealing with the policy options for inducing FDI, it is important to recognize that certain types of cost functions are within the domain of host governments while others are controlled by MNEs. For example, a decomposition of the production function of an MNE may disclose that costs such as labor and imported input may be influenced by minimum wage legislation, labor codes, legislated employee benefit schemes, or customs duties of the host country. However, other items of the production function, such as capital, might be within the control of MNEs. Similarly, a closer look at the cost of foreign operations, C, and the export cost differential, M, would suggest that host government policies on FDI taxes, subsidies, and investment incentives would affect C, while trade controls, tariffs, and export subsidies would affect M.

What policy options are open to host governments for attracting FDI? According to Hirsch’s equations, tax incentives or similar cost-reducing subsidies would lower the value of the left hand side of either equation, thereby inducing FDI. However, as demonstrated earlier, the efficacy of tax incentives for the purposes of attracting FDI is in serious doubt. Moreover, there is the serious problem of costly redundancy

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89 See Yelpaala, Efficacy of Tax Incentives, supra note 7; see generally sources cited supra notes 5 & 6.
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when tax incentive policies are combined with certain trade policies. For example, given the existence of an adequate market size, trade barriers would trigger defensive investments to protect markets acquired through exports to the host country. Thus, in Equation 2, if the trade policies of the host country increase the costs associated with exports, there might be no need to decrease other costs such as taxes in the host country. This confirms Robert Mundell's theoretical findings of a positive relationship between trade barriers and the flow of FDI. Since the influences of tax incentives on FDI are at best dubious, host countries' trade policies might also be important variables in determining the appropriate incentives for FDI.

Another important area in which host countries' policies could affect the flow of FDI funds is labor costs. Wage rates generally are influenced by local minimum wage laws and other statutes providing benefits to labor. The host government can, through its statutes, peg the minimum wages very low and provide very cheap overall protection and benefits to its industrial workers. It might even undertake to ensure that there are no strikes or other labor disturbances which are generally disruptive and costly to MNEs. Any policies along these lines might be oppressive to local labor, but they are, unfortunately, capable of influencing the MNE's location of plant in a host country. There are several examples of cheap-labor havens—generally called export-free zones—in several east and southeast Asian countries such as South Korea, Taiwan, Singapore, and Hong Kong. These export-free zones have attracted several manufacturing and assembly operations by MNEs looking for cheap and efficient production sites.

Through various statutes affecting labor unions, strikes, conditions of employment, and minimum wage laws, these countries promised to maintain a tight control over the conduct and benefits of labor within the export-free zones. It became an attractive and, indeed, common practice for MNEs to haul in duty free, materials or component parts from their various operations in developed countries for processing or assembly in these export-free zones for eventual re-export to their global affiliates. These labor policies, however, are hardly a statement of the distributive equities in MNE generated wealth. Labor might be paying a very high price for the total industrial expansion of these countries. It

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90 See Horst, Optimal Behavior, supra note 32.
92 Yelpaala, Impact of Industrial Legislation, supra note 20.
93 Id. See also 1 E. Utrecht, Transnational Corporations in South East Asia and the Pacific (1978).
would appear that even though the productivity of labor in these countries is sometimes equal to, or higher than, that of labor in some MNE home countries, their wages and other benefits do not reflect their contribution to the MNE system and wealth; nor are they in any way comparable to those of other workers in similar categories in the home countries.94

It would appear that the host country's labor laws and policies could provide an important incentive for industrial expansion in the manufacturing sector. However, the incentive policy prescription is not that obvious. Cheap labor costs alone will not provide the necessary incentive for FDI. The cost of labor in several developing countries is very low compared with that in the United States, but hardly attracts FDI. Moreover, the destination of most FDI in the world is the developed market economies which have higher labor costs than developing countries. In more recent years, the United States has started to become an important home country for FDI95 despite its comparative high labor costs. This suggests that the efficiency of labor might be an important factor here.

It is apparent from the MNE activities in these cheap-labor havens that, in addition to being cheap, labor has to be efficient. MNEs also appear to require a degree of flexibility that permits them to shuttle their resources, goods, and services within their systems at will. Therefore, the incentive value of cheap labor policies might well depend on the efficiency of labor and the degree of freedom of action of MNEs within their systems, rather than on the cheapness of labor. This raises the question of whether MNEs will take advantage of cheap labor when they would have invested at higher labor costs if their operational flexibility permitted. Given these indeterminants in the motivations of MNEs, any host

94 Yelpaala, Impact of Industrial Legislation, supra note 20.
Alternatives to Tax Incentive Policies  
7:208(1985)

country's labor policies designed to entice MNE operations should address the efficiency of labor and be sensitive to the various types of worker exploitation induced and sanctioned by the labor statutes examined here.

General labor policies designed with FDI in mind might be ineffective for several host countries. Effective labor policies for encouraging FDI should be task-directed and specific. Such policies should form part of a coherent and well-thought-out industrial policy incorporating an appropriate technology policy. Within this context, FDI labor policies may include labor costs, the efficiency of labor, and labor skills. The appropriate policy mix for each country would then depend upon the type of industry and investment, the technology input, the labor situation, and host government objectives. Labor costs might become an important factor in a situation where the efficiency of labor is not an issue. Where, for example, the host country with an efficient labor force has earmarked an industry to be internationally-competitive in price and quality, low labor costs could be an important inducement for FDI. However, for the purposes of distributive equities in the host country, complementary policies may be required to ensure that the burden of achieving such a policy objective is evenly shared by the rest of society. There are, however, several situations where the efficiency and levels of skilled labor, rather than labor costs, become important deterrents to FDI. Under such circumstances, the appropriate policies for encouraging FDI should address these issues.

Host government policies, as discussed earlier, could encourage FDI within well-defined situations through subsidies and incentives for training local labor. Such a policy might be most effective if used in conjunction with other complementary policies. There might be cases where a combination of policies would be appropriate. What is most crucial, is the purposeful development of policies to respond to the MNE system. For example, the general educational policies of a country might provide the necessary impetus to attract MNEs with long-term strategic FDI plans requiring a skilled labor force. In addition, the ownership of FDI and policies requiring local participation in MNE operations might also affect the efficacy of labor policies. Required in this approach is the active involvement of host governments in choosing the technology which enters their country's FDI process.

D. Summary

This theory calls for a more sophisticated approach to the FDI inducement process. A host government can, through well-reasoned anal-
ysis, break down the foreign investment process and identify those factors related to its policies or regulations which serve as operative disincentives to FDI. It can then work Hirsch's inequality conditions very selectively and come up with a policy mix that is likely to be problem-directed and effective within the framework of allocative efficiencies and distributive equities. Given the problem with tax incentives, this approach permits a host country to shift the emphasis from taxes to other policies. For instance, it is now widely accepted that certain types of restrictive trade policies—although unjustified on economic grounds—could trigger defensive investments to protect markets developed through exports. Trade policies that create uncertainty as to market access of products from exporting countries might also generate FDI. The current trends in Japanese investment in the United States seem to confirm both these observations.

The discussion in this section suggests that it may be instructive for policymakers to investigate the relationship between various types of government market intervention policies in the area of technology transfer and the FDI process. Certain government policies can be designed to encourage and facilitate FDI and the transfer of the appropriate technology to specific industries. Such is the case where the policy targets the industry, the technology, and the type of foreign investor.

Finally, much emphasis has been placed on the cost of labor as a policy variable. However, it would appear that the efficiency and productivity of labor might be, in some cases, a much more important factor in FDI. The cheapness of labor alone is hardly sufficient to induce FDI, since low-wage rates exist in several countries that nevertheless attract little or negligible amounts of FDI. An important host country FDI inducement policy for labor-intensive investments should include policies for providing an efficient labor force or certain concessions for the training of labor by the MNE.

IV. INDUSTRIAL ORGANIZATION THEORY

The industrial organization theory of FDI seeks to explain the growth of the MNE and FDI behavior in terms of oligopolistic market structures. According to this theory, the advantage of MNEs lies not so much in the possession of some unique intangible asset or know-how

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96 See Mundell, supra note 91. See also Horst, Optimal Behavior, supra note 32.
97 See generally the sources cited in connection with the General Motors-Toyota Joint Venture supra note 95.
as it lies in the stable structural traits of the industries in which they operate. Oligopoly with differentiated products based on technology protected by patents, or advertising protected by registered trademarks and brand names, goes to the very root of the FDI process in horizontal investments. Oligopoly also provides a fundamental explanation of vertical direct investments.99

It should be stated here that the intangible assets hypothesis and the industrial organization thesis are closely related yet somewhat distinct theories. Whereas one is a specific case of a particular market failure, the other is a general case of several industry-specific market imperfections which explain the foreign investment process. According to the intangible assets hypothesis, the failure of the rental markets for know-how and other firm-specific advantages explain why an MNE seeking the greatest return on its intangible assets would invest in their use rather than grant a license. However, the industrial organization theory considers the rental-market imperfection simply as a set of several traits within the industry, manifesting imperfections, which together explain the FDI behavior. Moreover, the two theories are connected in the sense that the profitable exploitation of technology depends on some degree of monopoly. Monopoly power facilitates the generation and protection of production secrets, superior technology, and their profitable use.

The industrial organization theory had its origins in a seminal doctoral dissertation by Stephen Hymer in 1960.100 His major thesis was that any attempt to explain the FDI behavior of MNEs must first explain why MNEs control or seek to control their foreign operations.101 The answer, he thought, was related to the imperfections in the industrial characteristics of the market and the rental markets for technology.102 Ownership and control of these foreign operations would then permit the MNEs to generate monopoly rents by removing competition. The second reason why MNEs desire to control their foreign operations has something to do with the imperfections in the rental markets.103 When the markets for renting, assigning, or leasing firm-specific advantages are characterized by imperfections, the MNE owning such advantages cannot exploit fully the rents attributable to them. To such an MNE, it would be most profitable to exploit its advantages abroad by establishing and controlling its operations as opposed to renting them.

99 Id.
100 S. HYMER, supra note 59.
101 Id. at 23.
102 Id. at 25-26.
103 Id. at 26.
Since Hymer's thesis, other economists such as Charles Kindleberger, Richard Caves, and Frederick Knickerbocker have explored and refined the industrial organization theory into a well-established explanation of the growth of the MNE and the FDI process. The current and prevailing theory on the industrial organization approach is perhaps best exemplified by the writings of Caves. According to Caves, once exports and licensing are ruled out as alternatives to exploiting firm-specific advantages, FDI must be explained by industry-specific factors. That is, FDI tends to take place in industries characterized by similar market structures both in the home and host countries. One can observe similar industrial concentration or clustering of foreign investors both at home and abroad. To determine which countries are potential sources for FDI, the following structural characteristics in their industries would be instructive: oligopoly with product differentiation; high R & D intensity geared towards knowledge creation; and barriers to entry confronting competitors.

Although tariff barriers are not directly related to any industrial characteristics of the source or host country, they nevertheless are a stimulus to FDI because they tend to reinforce the market structures in the host country. With seller concentration, high tariff barriers would enhance what may be characterized as a "herd mentality" in MNEs. When one firm jumps these tariff barriers by creating a plant in the protected foreign markets the rest will follow, since not doing so would place them at a competitive disadvantage. That is, they could not effectively compete with the first firm through their more expensive exports.

It is important at this stage to explain how these market structures are determinants of FDI. Oligopolistic market structures describe a situation of seller concentration. Where an industry is dominated by a few firms, product differentiation becomes an effective tool for the accretion and control of market power. Product differentiation also provides the oligopolist with an instrument for keeping competitors out of the market both at home and abroad. Given their size, financial resources, and marketing techniques, MNEs can more easily bear the significant costs associated with product differentiation through advertising. Moreover, their marketing techniques put them at a comparative advantage over compet-

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105 R. CAVES, MULTINATIONAL ENTERPRISE, supra note 7.
107 In a recent and interesting book, Caves has spelt out in greater detail the industrial organization theory. See R. CAVES, MULTINATIONAL ENTERPRISE, supra note 7.
108 Id.
itors, non-MNEs, and other potential foreign investors. These oligopolistic advantages constitute significant barriers to entry. Moreover, the legal protection accorded their industrial property rights in the form of brand names, trademarks, and patents ensures that the oligopolists can effectively control the degree of market penetration by firms or non-MNEs without such advantages. Since these protections exist both at home and abroad, an MNE, for monopoly profits, would seek to exploit its protected advantages abroad within industries exhibiting the same structural traits as at home.

The arguments pursued so far are closely related to barriers to entry, which make it more profitable for oligopolists to exploit their rent-yielding, firm-specific advantages abroad. As long as barriers to entry exist in particular industries, they are considered as providing a substantial advantage to offset the costs of foreign production. Moreover, these explanations of FDI apply to both vertical and horizontal investments.

A. Empirical Studies

It may be useful to start this section with a statement on the expected relationships between the industrial characteristics and foreign investment behavior. Various forms of entry barriers, as stated earlier, appear to give MNEs in oligopolistic industries a decided edge over non-MNEs. Richard Caves concludes that "each source of barriers to entry bears at least some relationship to the reasons why MNEs exist." They also explain why MNEs have an advantage "over newly organized firms, or over single-nation firms in getting over these barriers to entry." One should then expect high entry barriers and foreign investment activities to be highly correlated. One should also expect a close association between seller concentration and foreign investment behavior.

Since the emergence of the industrial organization theory, the extent of these relationships has been the subject of several empirical investigations. The results of some of these empirical studies have presented a

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109 Most host and home countries are signatories to the Paris Convention on Patents and also have the appropriate statutes protecting industrial rights. See, e.g., Patent Throughout the World (A. Greene ed. 1975); J. Baxter, World Patent Law and Practice (1985).
110 R. Caves, Multinational Enterprise, supra note 7, at 96.
112 R. Caves, Multinational Enterprise, supra note 7, at 16.
113 Id. at 96.
114 Id.
substantial amount of evidence confirming the relationship between seller concentration and the FDI process. Such studies indicate that the links between seller concentration and FDI appear to be universal to all MNEs, irrespective of their national origins.\textsuperscript{115} The importance of seller concentration to foreign investments was considered so high that Frank Fishwick remarked that foreign investments are never prominent in non-concentrated industries.\textsuperscript{116} It should, however, be pointed out that these studies do not prove any direct causation between seller concentration and FDI. They merely establish that there is a high degree of correlation between entry barriers and FDI.

One of the earlier but important empirical studies on the relationship between industry characteristics and FDI was by Frederick Knickerbocker.\textsuperscript{117} According to Knickerbocker, one way to explain the foreign investment behavior of MNEs in an oligopolistic industry is by oligopolistic reaction.\textsuperscript{118} Firms in a loosely-knit oligopoly are mutually interdependent. As such, the behavior of one firm is likely to trigger a defensive response from its competitors. The decision to go abroad by any firm in such an industry would induce a reaction similar to the "herd mentality." The rest of the firms will almost instinctively follow the leader. Hence, they checkmate the leaders' foreign investments to maintain their market share and competitive position.\textsuperscript{119} Thus, the foreign investment activities of several firms in an oligopolistic market will be determined by that of the leader. However, the determinants of the FDI of the leader is based on the basic industrial organization theory. Thus, oligopolistic reaction was designed to be a complementary explanation of the FDI process. Knickerbocker found empirically that the bunching or entry concentration of FDI was significantly correlated to industry concentration.\textsuperscript{120} In particular, entry concentration appeared to have been associated with a few industry leaders and most intense in industries where marketing capabilities were the most instrumental in the success of

\textsuperscript{115} The following are examples of studies pointing to the importance of seller concentration and FDI process: J. Dunning, \textit{American Investment in British Manufacturing Industry} 155 (1958); R. Caves & T. Pugel, \textit{Intraindustry Differences in Conduct and Performance: Viable Strategies in U.S. Manufacturing Industries} 100 (Monograph series in Finance and Economics 1980); R. Caves, M. Porter, A. Spence, & J. Scott, \textit{Competition in the Open Economy: A Model Applied to Canada} 86-87 (1980).

\textsuperscript{116} F. Fishwick, \textit{Multinational Companies and Economic Concentration in Europe} 43-44 (1982).

\textsuperscript{117} F. Knickerbocker, \textit{supra} note 106.

\textsuperscript{118} \textit{Id.} at 5.

\textsuperscript{119} \textit{Id.}

\textsuperscript{120} \textit{Id.} at 59-61.
firms.\textsuperscript{121} He also found that the post World War II expansion of United States FDI exhibited this bunching characteristic. The tendency to bunch together was greater the more an industry was characterized by oligopolistic market structures.\textsuperscript{122}

Several other empirical studies have demonstrated the relationship between other industrial characteristics, entry barriers, and FDI. For instance, Thomas Horst, in a study of United States manufacturing investments in Canada, found that firm size, as measured either by the volume of sales or assets, was a very important determining factor in plant location.\textsuperscript{123} In fact, Horst concluded that “once inter-industry differences are washed out, the only influence of truly separate significance is firm size.”\textsuperscript{124} He also found that the level of MNEs’ R & D expenditures in the industry as it relates to their United States sales was important in determining United States FDI in Canada.\textsuperscript{125} However, the R & D expenditure was taken as a proxy for product differentiation. The combination of firm size, technology creation capabilities, and product differentiation, as an important entry barrier, appears to have been confirmed here. Furthermore, Horst’s research appears to have been validated by Bernard Wolf in a study of global United States manufacturing investment behavior.\textsuperscript{126} Wolf also found that two major catalysts to United States manufacturing FDI globally have been firm size and technical know-how.\textsuperscript{127} Several other studies by economists stressing various aspects of the industrial organization theory seem to confirm their explanatory powers of the FDI process\textsuperscript{128} not only in horizontal investments but also in vertical investments.\textsuperscript{129}

B. Industrial Organization and Political Economy

The industrial organization theory, unlike other theories, presents an important aspect of the political economy of MNEs and FDI. Foreign direct investments, it is argued, may pose serious political and policy problems to host governments. Due to the size of MNEs and the manner in which the MNE system works, host governments may lose control

\textsuperscript{121} \textit{Id.} at 60.
\textsuperscript{122} \textit{Id.} at 78.
\textsuperscript{123} Horst, \textit{An Empirical Study, supra} note 55, at 260.
\textsuperscript{124} \textit{Id.} at 261.
\textsuperscript{125} \textit{Id.}
\textsuperscript{127} \textit{Id.} at 189.
\textsuperscript{128} \textit{See, e.g.,} Lall, \textit{Monopolistic Advantages, supra} note 75, at 102.
\textsuperscript{129} R. CAVES, \textit{MULTINATIONAL ENTERPRISE, supra} note 7, at 125-27.
over important sectors of their economies. Thus, FDI incentive policies might well complicate these political questions.

The issue of the political economy of FDI has been investigated by several economists. For example, Richard Newfarmer and Willard Mueller explored the impact of seller concentration at home and abroad on denationalization\(^\text{130}\) in developing countries. Since seller concentration in the home country generally measures the market power of industry participants, the fact that it is replicated in the host country, also implies the transfer of such market power.\(^\text{131}\) Therefore, FDI carries with it some market power based upon size or the accretion of size. The transfer of this market power to the host country permits the MNE to exercise some control over the host country’s economy either directly or indirectly.\(^\text{132}\)

Studies on denationalization, market power, and several of the dependency-type analyses\(^\text{133}\) raise interesting and important questions about the political economy of the MNE and planning policy options for host developing countries. Although these studies are extensive and complex, we are only interested in a limited issue raised by them. For example, what should be the nature or form of the host country’s FDI legislation or policies given that the MNE can sometimes engulf the host country in controversies with wide-ranging implications? Current con-

\(^{130}\) R. NEWFARMER & W. MUELLER, supra note 33.


\(^{132}\) Id. See also R. NEWFARMER & W. MUELLER, supra note 33, at 43-44.

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...troversies surrounding the MNE have involved legal, economic, and political considerations of nation states involved in the MNE system. Thus, a host developing country might suddenly find itself involved in an MNE-generated controversy on issues ranging from its own national economic policies to the geo-political or national security concerns of a foreign state.

For most developing countries seeking to attract FDI these concerns might be only academic. However, for those countries that have been most attractive to the MNE such as Brazil, Mexico, and South Korea, these considerations could be important in adopting well-balanced laws for attracting FDI. They are also equally important for countries that have not been very attractive to FDI but have, to some extent, permitted issues of the political economy of FDI to dominate their policies, perhaps to the detriment of other policies. The relevance of these factors is discussed in the next section.

C. Incentive Policy Implications

Given the possible serious problems that might arise in relation to the political economy, denationalization, and the power of MNEs, it is immediately doubtful whether host countries, particularly host developing countries, should engage in any systematic inducement of FDI.

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The presence of MNEs in a host country often drastically changes the political and economic calculus of that country. MNE operations do not only often generate a volatile chemistry in the environment, but they also touch upon the very sensitive nerves of those who want them. The question then is: should a host country, without the necessary power or institutional framework for checking the conduct of MNEs, engage in a policy that will result in the loss of control over its industrial and economic decision-making process? In the alternative, should such a country at least be willing to reduce its policy autonomy or efficacy by enticing MNEs whose global strategies and decision flexibility would tend to thwart that country's policy efforts?

The answer to these questions hardly requires economic analysis or pure and simple legal arguments. It requires a fairly sophisticated understanding of the MNE system, the areas of conflict, the cost and benefits resulting from MNE activities, and the general international environment. This section will explore the possible incentive policy implications of the industrial organization theory against the background of the socio-economic and political implications of the MNE.

1. Control and FDI Policy

The fundamental thesis of the industrial organization theory is that MNEs engage in FDI because they seek ownership and control of their operations in foreign countries. The reason why they control or seek to control these operations is that several market imperfections make it difficult for MNEs to make the greatest returns on their firm-specific advantages in any normal arms-length transactions in the external markets. Foreign investments, therefore, tend to take place in industries characterized by certain imperfect market structures both at home and abroad that would increase the returns to MNEs beyond normal profits. In other words, industries characterized by oligopoly, product differentiation, high R & D intensity, and barriers to entry would most likely be both the source and destination of foreign investments. It is clear, therefore, that one of the reasons for FDI is control.

Any search for the appropriate industrial policy options of host countries should begin with the issue of control. If ownership and control is central to the MNE as an MNE, then one should observe a marked preference for MNEs to cluster around countries in which the opportunity to control their operations is greatest. According to the industrial organization theory, the more permissive the host country's environment towards greater control of FDI by MNEs, the more favorable that environment should be to MNEs. Therefore, one should expect a
significant and positive correlation between host country legal permissiveness and flexibility towards control and MNE involvement in that country. A policy that permits at least majority-owned and at most wholly-owned MNE subsidiaries should be desirable for FDI. Under either situation, the MNE can exercise *de jure* and *de facto* control over its operations. It can decide production levels, the price of intra-firm transactions, royalty rates, markets to be serviced, and every other aspect of its operation without interruptions from the host government or its local partners. Accordingly, a legislative policy that does not permit these ownership and control structures is more likely to discourage FDI.

The idea of using ownership and control as an incentive policy instrument is a novel idea which deserves special scrutiny. It should be emphasized that, so far, host country incentive policies do not appear to incorporate this option. Nor has the literature on incentives investigated the possibility of using ownership and control as a means of attracting FDI. The reasons why this option has escaped the literature might be partly due to the political economy of MNE discussed earlier, the economic nationalism of host countries, and the complexity of the issue of ownership and control. Therefore, to develop any incentive policy prescriptions, it is important to analyze in some detail the issue of ownership and control. It is also important to find out host countries' attitudes toward ownership and control and how MNEs respond to different attitudes.

2. Attitudes of Host Countries

The issue of control is a very complex phenomenon that transcends any classification of nation states by ideological, economic, or political power.\(^{137}\) Whether a nation state should permit foreign ownership of its economic resources or means of production in its industries raises very important questions including the very existence of such a country as an independent sovereign state. Nation states are thought of as sovereign territorial units concerned primarily with the welfare of their citizens. Economic nationalism, therefore, appears to be logical for the exercise of real sovereignty—political and economic. Foreign ownership and control, depending upon its character, depth, and shape may not only im-

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\(^{137}\) Economic nationalism has always been a phenomenon that transcends the level of economic development or political ideology of countries. These concerns are expressed in various ways. *See Hearings on United States Policy Toward International Investment Before the Senate Comm. on Foreign Relations, Subcomm. on International Economic Policy, 97th Cong., 1st Sess. (1982); OECD, International Investment and Multinational Enterprise: Mid-term Report on 1976 Declaration and Decisions (1982); UNCTC, Third Survey, supra note 1, at 79-87. See also C. Bergsten, T. Horst & T. Moran, supra note 26.*
pinge upon the exercise of sovereignty but may also negate it completely. In such a situation, the concern of nation states is that they may become pseudo-sovereign states absorbed in the economic space of more powerful trading partners. Under such circumstances they may effectively cease to have the capability of serving the best interests of their citizens.

In the past fifteen years, political considerations and ownership and control have increasingly gained the attention of both developed and developing host countries. Foreign ownership and control are seen as exposing host countries to the vicarious dependence on foreign government policies through foreign investors. This limits the policy autonomy of host countries. At the same time, reliance on foreigners in important industries exposes host countries to important concerns of vulnerability and sensitivity dependence. The host country is thus hardly able to absorb the shocks of major international disturbances in dependent industries. The prospect of not being able to respond through domestic policy to changes in the international economy appears unpalatable to host governments. Moreover, host countries see a need for self-reliance, promoting local entrepreneurship and encouraging certain distribution patterns.

In view of these considerations, there now appears to be a growing convergence in policies on control adopted by developed market economies and developing countries. Recent policy changes in Canada, France, Australia—and the ever-mounting pressure in the United States to end its policy of indiscriminate neutrality towards certain types of FDI and to require monitoring of FDI—indicates a new trend. In the case of developing countries, several policy patterns have emerged, ranging from legislation restricting foreign ownership and control in priority, pioneer, or promoted industries, to general rules of law restricting foreign ownership and control. Although the specific approaches of developing countries are numerous, for the purpose of discussion, one can categorize them into two broad groups. First, there are those countries that have tried to control only the operations and intra-firm transactions without prescribing ownership structures. Second, there are others that have combined operational and intra-firm transactional controls with specified ownership structures.

Influenced by a more sophisticated understanding of the political

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138 UNCTC, THIRD SURVEY, supra note 1, at 60, 70.
140 UNCTC, THIRD SURVEY, supra note 1, at 78-82. See also OECD, CONTROLS AND IMPEDIMENTS AFFECTING INWARD DIRECT INVESTMENT IN OECD MEMBER COUNTRIES (1982).
141 UNCTC, THIRD SURVEY, supra note 1, at 60.
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the economy of the MNE and its operational dynamics, countries in the first category appear to draw the important distinction between ownership of the operational resources and control over their use. Ownership of the operations by MNEs Per se does not raise questions about allocative and distributive efficiencies in an economy. It is how these operations are controlled or managed that might raise serious questions about the efficient utilization of resources and distributive equities. The extent to which management is responsive to contradictory home country policies intensifies the concern over sovereignty. Some countries, such as Brazil and others in Latin America, have introduced very complex and sophisticated regulatory schemes designed to monitor transactions within the MNE system and control the channels of transmission and flow of profits, dividends, fees, and other charges within the system. A number of studies on these regulatory schemes point out that, even though they might have been motivated by a sophisticated understanding of the MNE system, they were ad hoc and uncoordinated in nature. Consequently, they were ineffective. Moreover, their efficiency was further undermined by the unavailability of sufficient enforcement resources.

The second category of regulatory schemes appears to be most prevalent in developing countries. Countries such as Ghana and Nigeria introduced various regulatory schemes starting with controls over transfer pricing, remittances, and requiring local participation by statute. Local participation statutes were motivated by many factors. Several of the

142 For examples from Brazil, see Foreign Capital Inducement Law No. 4.131 of 3 Sept. 1962 (as amended by Law No. 4.390 of 29 Aug. 1964); Executive Act No. 55.762 of 17 Feb. 1965 (consolidating Law No. 4.131 of 3 Sept. 1962 and Law No. 4.390 of Aug. 1964); Normative Act No. 15 of Sept. 11, 1975; and Normative Act No. 64 of Sept. 16, 1983. For examples from Columbia, see Decree 1900 of 1972, (implementing Decision 24 of the Andean Common Market concerning the treatment of FDI, patents, trademarks and royalties); Law 55 of 1975 (restricting new investments in banking); and Finance Technology transfer laws—to be found in Decree 444 of 1967, Decree 688 of 1967, and Decree 1234 of 1972. For examples from Mexico, see Law for the Promotion of Mexican Investment and Regulation of Foreign Investment, 1973; Law Concerning the Control and Registration of the Transfer of Technology and the Use and Exploitation of Patents and Trademarks, 1981; Law on Inventions and Trademarks, 1976. The United Nations Center on Transnational Corporations has recently compiled a list of the appropriate legislation affecting FDI in these and other countries. See UNCTC, NATIONAL LEGISLATION, supra note 2.


144 Rosenn, supra note 143, at 352-54; Correa, supra note 143, at 408.

145 For Ghana, see the Investment Policy Decree, 1975 (NRCD329). Since this Decree, Ghana has enacted other laws designed to encourage FDI. The most recent legislation is the Investment Code, 1985 (P.N.D.C.L. 116) which repealed the Investment Code, 1981 (Act 437). For Nigeria, see
host governments seriously concerned about the nature, quality, and impact of MNE activities on their economies decided to induce greater and more efficient integration of MNE operations into their local economies through legislation. MNE operations, they thought, would be most beneficial to them if they generated greater linkage effects and resulted in better and more efficient local resource utilization.

To ensure that MNE operational decisions would take into account national industrial and economic policies, output targets, export levels, and even the balance of payment positions, those host governments enacted local participation laws which demanded majority local ownership of MNE operations within their countries. These types of laws have become commonplace. They exist within several countries in Southeast Asia, Africa, and Latin America.\textsuperscript{146} Such host governments seem to believe that the simple fact of local majority ownership, dictated by law, will translate into effective control. According to the theory, those laws should discourage FDI. However, the real question is: what is their impact on the behavior of MNEs? Do these legislated local majority ownerships translate into effective control by local individuals, and hence the achievement of host government objectives?

3. MNE Responses to Ownership and Control Laws

The extent to which ownership and control laws of the type described above have been effective depends upon the behavior of MNEs. Until about the last decade, there appeared to have been a definite preference of most MNEs (particularly United States MNEs) for wholly- or majority-owned operations in developing countries. MNEs in more recent times have demonstrated greater flexibility with regard to ownership and control. There is a growing trend toward accepting minority ownership positions of FDI in developing countries. However, that an MNE holds a minority interest is not always dispositive of the locus of control. A United Nations report on MNEs indicates that, notwithstanding their minority equity positions, MNEs still exercise substantial \textit{de facto} control over their operations.\textsuperscript{147}

In a recent survey on this issue, it was found that the experience of several countries in legislating control has been unsuccessful.\textsuperscript{148} MNEs from Europe, Japan, and the United States all seemed to find a way

\textsuperscript{146} See supra notes 84-87.
\textsuperscript{147} UNCTC, \textsc{Third Survey}, supra note 1, at 62-64, 163.
\textsuperscript{148} See Yelpaala, \textit{Impact of Industrial Legislation}, supra note 20.
around local majority participation statutes to maintain effective control, at least over very critical aspects of their operations.\textsuperscript{149} Moreover, the local majority owner does not always care about legal right of control. Most often the local owner still needs the MNE because it has the resources, access to markets, and an international or global network. For profitable operations, the local majority owner usually relies on the MNE, resulting in relinquishment of effective control. Several other studies have confirmed the importance of the issue of control to MNEs even though legal ownership may be declining in importance.\textsuperscript{150} MNEs operating in Nigeria, for example, have adopted schemes, structural reorganizations, and several other methods to maintain control which were violative of the spirit and letter of the Nigerian Indigenization Decree.\textsuperscript{151} For instance, an MNE manufacturing for local distribution would divide its operations into two parts: (1) manufacturing, which would be wholly-owned by the MNE; and (2) marketing and distributing, a joint venture in which the MNE would take a minority interest but find local partners who are known to be incompatible with one another. The two companies would be in the same building and share the same board of directors and officers.\textsuperscript{152} As such, the MNE would maintain an effective control over its entire operations notwithstanding the law.

What is obvious from the Nigerian experience is that majority local participation statutes, by their nature, stress ownership and not effective control. They confer only the legal right of control whereas the effectiveness of the right is determined by other extraneous and non-legal factors. Thus, the local majority owner might not have the know-how, managerial expertise, or operational experience to run the operation efficiently. Moreover, the industries normally targeted for local majority ownership are the same industries in which the MNEs enjoy a decided monopolistic advantage over the local partner. Such an advantage would often be used subtly to control the operations effectively. Therefore, several of the host country's desires for economic independence and policy autonomy remain mere wishes and somewhat elusive.

### D. Policy Prescriptions

The response of MNEs to various regulatory schemes of host coun-

\textsuperscript{149} Id.


\textsuperscript{151} Biersteker, Illusion, supra note 150, at 215-18.

\textsuperscript{152} This is what Biersteker calls the two company strategy. \textit{Id.} at 216.
tries indicates quite clearly how adaptable MNEs can be in the face of a changing legal environment. It also suggests that MNEs attach a great deal of importance to the issue of control. They quickly recognize the distinction between legal control and effective or operational control and tend to accept situations where the effectiveness of control is maintained by them. In terms of developing incentives for FDI, the *apparent* policy prescription for host countries would then be to denationalize FDI operations by repealing all the MNE control legislation or by setting up ownership laws which do not interfere with the desired MNE effective control.

This policy prescription is dubious for a number of reasons. First, one wonders whether control and FDI are necessarily inseparable concepts. Control, according to Stephen Hymer, is only a means to an end—maximizing returns on firm-specific advantages within certain imperfect market structures. Control might well be a means to monopoly profits. It might also be a statement of the level of uncertainty in a particular environment in which the MNEs operate. If MNEs control their operations to maximize profits, the lack of control need not result in lower levels of FDI since the loss of control does not necessarily imply lesser returns. Moreover, as discussed under the intangible assets hypothesis, controlling MNE operations in industries characterized by several market imperfections should result in optimal levels of FDI and allocative efficiencies in host countries. Besides, the growing number of joint venture operations between different MNEs in the developed market economies seems to suggest that control is not essential to foreign operations of MNEs since at least some of them normally would take a minority position in those operations. The desire for control might then be a manifestation of some uncertainty about targeted profit levels or some other problem within the environment of the host country.

Whether MNE control would work as an incentive for FDI would, therefore, depend upon the nature of the markets within which MNEs operate. The more imperfect the markets, the more effective control would act as an incentive in the FDI process. Market imperfections would tend to increase the level of uncertainty reflected in the cost of the business environment, thereby requiring MNE control for efficiency and profitability. In addition, the existence of certain forms of uncertainty would require at least effective control to induce FDI. Where, for example, the operational utility of FDI is dependent upon uncertain levels of local capabilities, scale, efficiency, and quality for the product to be internationally competitive, effective control might operate to induce FDI. Such a policy could then be complementary to the technology policy dis-
cussed earlier. However, market imperfections in certain industries may also require local control. This is most evident in the extractive industries. The MNE might be encouraged to invest without control when most of the risk in the long-run is borne by the host country. That seems to explain production sharing, service contracts, and staging in mineral contracts.

Since MNEs have shown a remarkable adaptability in the area of ownership and control, and host governments have continued to express concern over the degree of asymmetrical vulnerability dependence on foreign participation in their local economies, breaking down the FDI package could lead to an accommodation on the issue of control with respect to both the host governments and MNEs. As demonstrated earlier, host governments’ policy objectives are multiple. A government might want ownership and control over a manufacturing industry because it wants to encourage the acquisition of technology or managerial expertise. It might want local control in an industry that produces an important manufactured export product. A country might also want to develop competent local capability in an industry requiring a capital-intensive and complex technology as in the case of the chemical and petrochemical industries. The policy and strategy for ownership and control in these cases could depend upon the availability of suitably trained technicians and management either locally or internationally for hire. On the other hand, the MNE might see control as essential for monitoring a new technology, maintaining product quality, or even for ensuring that the particular operations fit into the MNE system. These goals are not all necessarily inconsistent with those of the host government.

It appears that the issue of control could be used as an incentive for FDI by host governments. For instance, a policy encouraging foreign joint venture operations in an industry where local control is desired could be achieved in different ways. The host government could use a fade-out, production sharing, service, or management contracts effectively as incentives. In the case of manufactured exports, the MNE may only invest if it has control over the manufacturing process for quality reasons. A fade-out policy can accommodate the MNE concerns where it is allowed to control the operations, but to phase-out such control to suitably-trained local management within a definite amount of time. In the alternative, the policy could allow MNE control over only the manufacturing process subject to a fade-out scheme. This approach should result in allowing MNE temporary control over crucial aspects of FDI operations where productivity, efficiency, and quality will be enhanced in
the short- and long-term. The host government, the local partner, and the MNE all stand to benefit from his policy. In fact, for this approach to be effective, it would require a well-developed industrial policy which either targets or ranks various industries for development and foreign participation. It should result in some pragmatic response to the type, timing, and process of effective control by local entrepreneurs. Because the terms will be negotiated and will constitute part of the government’s policy for encouraging FDI, the approach should decrease the uncertainty to MNEs, stabilize their FDI expectations, and induce FDI as a whole.

Finally, any attempt to address squarely the issue of control, certainly one of the most important concerns of MNEs, will be beneficial to both the host government and the MNE. At least, the host government would again be actively involved in the FDI process. The experience of several countries suggests that active involvement might be very important for the type, size, timing, and control over FDI.\textsuperscript{153} This policy prescription is likely to be unpopular because of the issue of monopoly rents and the politico-economic ramifications of denationalization. However, an efficient use of this policy option must be put within the context of a host country’s short- and long-term economic objectives. It might be effectively used where the host country develops some capability to effectively monitor aspects of MNE operations such as profits and intra-firm transactions. On efficiency grounds, therefore, various local statutes seeking to reduce inefficiencies in the market by controlling MNE intra-firm transactions are well-motivated. However, these regulatory schemes should be such that they do not interfere with host governments’ industrial policies and operational efficiencies. Ownership and control structures should then encourage maximum and efficient resource utilization and output levels within the context of host countries’ distribution goals.

E. Other Policy Issues

The industrial organization theory also posits that certain industrial traits at home and abroad induce FDI.\textsuperscript{154} With regard to developing host country policies, it is important to determine whether the industrial traits work as a pull from or a push toward the host country. In other words, which market structures are most active in generating FDI behavior, those of the home or host countries? Are market imperfections of the home needed first to serve as a push of FDI to the host country?

From the literature surveyed so far, it would appear that the indus-

\textsuperscript{153} Yelpaala, \textit{Impact of Industrial Legislation}, \textit{supra} note 20.
\textsuperscript{154} Caves, \textit{supra} note 98, at 24.
try specific characteristics of the home country serve as a push while those of the host country serve as a pull for FDI. According to the theory, MNEs seek to replicate their home country industrial traits and market structures abroad. By accomplishing this, they can then easily exploit the monopolistic advantages which were the basis for their market power at home. Sanjaya Lall has suggested that MNEs have monopolistic advantages at home which may be transferable to the host country.\textsuperscript{155} Therefore, it would appear that an oligopolistic market structure in the home country would be a necessary, but not sufficient, condition for FDI. Where the host country has no policy of restricting FDI, and the opportunity to replicate the industrial characteristics and exploit the monopolistic advantages exist, the market structure of the host country will serve as a pull for FDI. As long as the opportunities exist in the host country for MNEs to reap monopoly profits or to maintain their relative market positions, why should the host country also be called upon to induce FDI through tax incentives or other subsidies? With the transferable monopolistic advantages at home and the profitable opportunity to exploit them abroad (along the lines discussed in the theory) the necessary push and pull exist and no incentives are required, at least not tax incentives.

In fact, intuitively, the basic thesis of the theory militates against tax incentives. Seller concentration generally is indicative of the market power of MNEs. Given their dominant position in the host country’s economy or the potential for it, they may charge monopoly prices and reap excess profits. Take, for instance, the several and different types of intra-firm transactions that could be used to increase the returns to a parent company, as discussed earlier. When these are taken together with the potential for excess profits, there is no reason to offer incentives to increase these returns to the MNEs. In fact, Richard Caves suggested that, when excess profits are earned, host countries should impose an excess profits tax.\textsuperscript{156} Since the MNE and its activities are a result of market imperfections generated at home which may lead to economic and political power abroad, it is doubtful whether host countries should create a permissive environment that would complicate their policy options. Based on the basic tenets of the theory, tax incentives would be both misplaced and redundant.

The argument is further strengthened by Fredrick Knickerbocker’s findings of oligopolistic reaction.\textsuperscript{157} If foreign investors have a kind of a

\textsuperscript{155} Lall, Monopolistic Advantages, supra note 75, at 102.
\textsuperscript{156} Caves, supra note 98, at 24.
\textsuperscript{157} F. Knickerbocker, supra note 106, at 5.
"herd mentality," all that is required is to induce the first MNE and the rest would follow. The first MNE will not move, however, unless it can replicate and exploit its monopolistic advantages abroad. Tax incentives merely increase the monopoly returns and speed up the process. Therefore, tax incentives are not effective as an inducement but are only relevant, perhaps, as to the timing.

It would appear that certain host country policies could induce FDI under this theory even if the desirability of doing so is in doubt. The possession of technology, trademarks, brand names, and other industrial properties protected by law give MNEs the opportunity to control their entrepreneurial resources and create an effective barrier to entry. This implies that both the home and host countries should have effective industrial property protection laws which can give MNEs some monopoly power to exploit their know-how and effectively differentiate their products from others. These laws would assist MNEs in the erection of the necessary barriers to entry and hence give them the opportunity to reap monopoly or near-monopoly rents. Where effective entry barriers exist, either through inducement or not, MNEs would be inclined to exploit their monopolistic advantages in the host country. However, from a cost-benefit perspective the host government might consider countervailing disincentives to monopoly prices both in the goods and rental markets. The host country may set limits on rents, royalties, and fees chargeable on the transfer of know-how, management, and technical service agreements to subsidiaries as has been done, for example, in Brazil. It may also institute effective accounting control systems and subject monopoly profits to excess profits taxes.

Another area of possible host government policy is in the creation of technology. As shown earlier, there is a positive and strong relationship between technology intensity and FDI. Industries that are characterized by heavy expenditures in knowledge creation are also very active in foreign investments. One then wonders whether host countries should not play an active and aggressive role in the R & D component of FDI. Given the growing concern of several host developing countries over the appropriateness of technology, host countries should seek to influence the technology that enters the FDI at the R & D, or adaptation stage. Government subsidies on specific technology development based upon host country or regional needs might be appropriate. These incentives would relate to the cost of technology development. That is the most appropriate stage to influence the nature of the technology that enters the host country's industry.

It should be stressed that these types of host government subsidies
alone would not be sufficient for FDI since the theory suggests several other elements. In addition, the financial resources of MNEs are comparatively much larger than certain host countries, thereby raising the question of the appropriateness of these subsidies in relation to the financial ability of host countries. The quest for monopoly profits, however, is not likely to take MNEs to such countries. Besides, any attempt by host countries to actively participate in the direction and nature of their economic fate is required. Even if such an attempt is ineffective in the short run, it will nevertheless help to focus attention on the most important policy issues and areas of conflict.

Finally, in trying to determine the incentive policy implications, it is also important to keep in mind another crucial element: the flow of FDI occurs between similar industries even though diversification across the industry is not impossible. This implies that any incentive policies should be industry specific. Host countries should focus their FDI inducement efforts at specific characteristics of industries seen as important to their industrial development. This approach provides some flexibility to the host government in the choice of its policy instruments and the selection of beneficiary firms. It would also reduce the cost of the incentives and possibly eliminate redundancy.

F. Summary

The industrial organization theory permits a serious investigation of the policy dilemmas of host countries seeking economic development and independence through FDI in a world of MNEs dictated by free enterprise and perfect competition. For the purposes of incentive policies, the fundamental tenets of the industrial organization theory do not \textit{a priori} suggest any tax incentive policies for FDI. In fact, they suggest a possible excess profit tax on FDI monopoly income. However, under this theory, certain industrial traits may present some policy options for host countries.

If MNEs actually prefer to invest in industries characterized by certain market imperfections and also to own and control their foreign operations because of these market imperfections, then policies designed to encourage FDI should focus on either the market imperfections or ownership and control. Market conditions in the world are generally characterized by these imperfections, thereby suggesting that host countries need not do anything. However, in the case of ownership and control, the theory suggests denationalization or policies that would encourage foreign ownership and control. The issue of ownership and control is, nonetheless, so complex that this policy prescription is not necessarily
appropriate. In view of the political economic heat that the MNE often generates in the host country, and various host country industrial and distribution policies, ownership and control can be used as a means of encouraging certain types of FDI. In addition, the host country might try to encourage certain initial technology creation activities and improve its protection of industrial property rights.

V. INTERNALIZATION THEORY OF FDI

Internalization is the most ambitious recent attempt to develop a comprehensive, complementary, or eclectic theory of the FDI process. As a concept, internalization was first developed by R.H. Coase in 1937 to explain the process in the domestic context. The theory, however, provides some basis for explaining the motivation for FDI and the growth of the MNE. It was synthesized by Peter Buckley and Mark Casson, used by John Dunning to explain his eclectic approach to FDI, and systematically developed into a general theory of FDI by Alan Rugman. According to Dunning, no theory standing alone can explain such a complex phenomenon as the FDI process. All the major theories of FDI must be seen as complementary to one another under the unifying theoretical theme of internalization.

Internalization may be defined as bringing under the same ownership and control, the same activities linked together by markets. The firm, according to the internalization theory, is "an organization for allocating resources without the exchange of ownership." There are two sets of markets within which a firm may transact its business: the external markets and the internal markets. External markets refer to market transactions involving arms-length deals which result in the exchange of ownership. On the other hand, internal markets concern deals which are merely notional and in which ownership does not change. Internalization will take place in response to any type of distortion or market imperfections in the external goods and factor markets. The basic motivation behind internalization is efficiency. The operational efficiency of any business requires that it be able to coordinate various aspects of its

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158 Coase, supra note 59, at 386.
159 P. Buckley & M. Casson, supra note 35.
160 J. Dunning, Int'l Prod., supra note 37.
162 J. Dunning, Int'l Prod., supra note 37, at 33.
163 See M. Casson, supra note 65, at 45.
164 Id.
165 P. Buckley & M. Casson, supra note 35, at 36-37.
activities through a set of efficient external markets—in the goods and factor markets. However, the markets for several intermediate products, defined broadly to include intangible assets, human skills, knowledge, and semi-finished products, are either inefficient or difficult to organize. Internalization permits a firm to by-pass these inefficiencies or replace them with its own internal efficient set of markets. It is, therefore, the internalization across national boundaries that explains foreign production, sales, and other operations of MNEs.\textsuperscript{166} The result of internalization is that each market is fragmented, since each MNE constitutes a separate and independent system from other participants in the same market. Thus, there are few if any intersectoral linkages with internalization.

The internalization paradigm suggests that the MNE is the efficient alternative to the lack of free trade.\textsuperscript{167} In other words, if the world were characterized by free trade there would be no need for the MNE. However, since the underlying conditions for a perfect competitive model in the goods and factor markets do not hold in the normal world, free trade between nations is destroyed. The use of the MNE and the FDI process is then an efficient second-best response to the existence of market failure. In the normal Herscher-Ohlin world, location-specific endowments lead to international trade. Under the internationalization paradigm, however, firm specific endowments or advantages internal to the MNE, together with industry specific factors, lead to FDI. These firm specific advantages are the same as those described earlier as intangible assets. The intangible assets hypothesis and the internalization theory both view the exclusive possession of some proprietary knowledge, know-how, or trade secrets as very important in the FDI process. They also consider these assets to have the character of \textit{public goods} and transactions in them are characterized by market imperfections. These imperfections relate to the industry specific factors.

The two theories provide different explanations of the FDI process emerging from the same sources of market imperfections. The intangible assets theory, its critics claim, ignores the costs associated with the creation of the firm-specific advantages.\textsuperscript{168} Moreover, it predisposes one to think of a single firm-specific asset, innovation, or endowment, in which case leasing would be most appropriate. Consequently, the theory fails to focus on the methods of the transmission of innovative capability

\textsuperscript{166} Id.
\textsuperscript{167} Rugman, supra note 161, at 366, 368.
which requires a set of efficient markets. FDI takes place under the intangible assets theory to make some returns on a costless firm-specific advantage. On the other hand, under the internalization theory, FDI is motivated by the efficiency considerations of MNEs. Considerations that induce them to attempt to own or control markets of their specific endowments so that they can appropriate a fair return for their costs in knowledge creation expenditures.

The market imperfections that may trigger internalization are several, but can conveniently be categorized into two groups: (1) market imperfections which may arise from exogenous government-induced inefficiencies, and (2) market imperfections which arise from normal market failure in the goods and factor markets.\(^{169}\) Government-induced imperfections will normally arise from government intervention in the international markets through tariffs and non-tariff barriers, controls, and restrictions on international capital flows, foreign exchange regulations, and discrepancies between corporate tax rates.\(^{170}\) These imperfections, it is argued, provide an incentive for internalization at the international level. For instance, exchange control restrictions or corporate tax differentials would induce an MNE to shift its profits form one country to another through its own internally-controlled transfer pricing system by the use of a foreign subsidiary.

Similarly, several non-government market failures will provide the incentive for internalization. For instance, imperfections may exist in the intermediate goods markets where the transactions are characterized by significant time lags without any efficient futures markets. Discriminatory pricing may be required to exploit market power.\(^{171}\) There may also be significant disparities in the bargaining power between buyers and sellers of intangible assets. Finally, in the case of bilateral concentration of market power, the costs of sanctions inherent in the bargain process create some uncertainty and, therefore, may require some joint control or ownership. Any or all of these market imperfections which might be structural or cognitive would induce an MNE to replace these imperfections with its own internal efficient markets for these goods.

Given the advantages of internalization outlined above, MNEs will internalize their international operations if and only if the benefits outweigh the costs of doing so.\(^{172}\) Of importance to the cost function of an internalizing MNE are those associated with generating its firm specific

\(^{169}\) P. BUCKLEY & M. CASSON, supra note 35. See also Rugman, supra note 161, at 371.
\(^{170}\) P. BUCKLEY & M. CASSON, supra note 35, at 44.
\(^{171}\) Id. at 38.
\(^{172}\) Id. at 37-40.
advantages described as "public goods." Internalization should be seen as an attempt by the MNE to make some positive net returns on its costly prior outlays in knowledge-generating investments. These costs are not sunk costs. Internalization will also involve several other cost which have to be minimized. First, internalization will increase the resource costs resulting from market fragmentation. Second, since internationalization might involve a monocentric or polycentric control system of geographically-dispersed units of internalized operations, both the administrative and communication costs of coordinating these units will increase and, thereby, increase the general overhead costs. Finally, host governments might also increase the costs of internalization by various types of overt and covert discriminatory actions against foreign-owned or -controlled subsidiaries. These types of politically-induced costs of foreign operations will be positively correlated to the political stability of the host country. When these cost items, weighed against all the benefits, are not prohibitive, internalization of foreign operations will take place.\footnote{Id. at 44.}

Internalization, its proponents assert, is a general theory of FDI since it is eclectic and seeks to incorporate other theories of FDI as consistent and complementary explanations of the FDI process. It is claimed that internationalization incorporates profit maximization behavior in the real world of market imperfections—an element not considered by the neo-classical Herscher-Ohlin profit maximization theories.\footnote{See Rugman, infra note 161, at 371-73, and J. Dunning, INT'L PROD., supra note 37.} As shown above, it incorporates and explains further the intangible assets hypothesis. Furthermore, it also explains the industrial organization theory as a complementary part of internalization. Oligopolistic market structures, collusion, and barriers to entry all manifest certain imperfections in the external market which explain the desire for ownership and control, thus internalization.\footnote{See Rugman, supra note 161, at 371-73, and J. Dunning, INT'L PROD., supra note 37.} Finally, internalization incorporates Raymond Vernon’s product cycle hypothesis which explains FDI as being sequential and determined by the life cycle of the product: innovation, spread, maturity, and senescence.\footnote{The product cycle hypothesis was one of the most important explanations of the FDI process of United States manufacturing enterprises. It has, however, been partially rejected by its author and other economists as an important explanation of FDI. See Vernon, International Investment and International Trade in the Product Cycle, 80 QUART. J. ECON. 190 (1966). For Vernon’s reconsideration of the product cycle hypothesis, see Vernon, The Product Cycle Hypothesis in a New International Environment, 41 OXF. BULL. ECON. STATIST. 255 (1979). For a critic’s view of it, see Giddy, The Demise of the Product Cycle Model in International Business, 13 COLUM. J. WORLD BUS. 90 (1978).} FDI takes place at the
maturity stage of the product. The connection between internalization and the product cycle hypothesis is the initial motivation for research and knowledge creation which lie at the center of internalization. Once the initial outlays in and motivation behind R & D are explained, everything about the product cycle hypothesis follows.\textsuperscript{177}

A. Incentive Policy Implications

A discussion of the incentive policy implications of the internalization theory requires an understanding of the importance of this theory to the definition of the MNE adopted in this study. According to the theory, the MNE is motivated by the desire for internal operational efficiency which can more easily be achieved through ownership and control. As such, the internalization theory helps to explain why, functionally, the MNE constitutes a multinational system. The MNE is more like an organism responding to various internal and external stimuli given certain internal capabilities. It seems to function best when it is within an environment where it controls its operations. Thus, the theory seems to explain the reasons for the preference of MNEs for shuttling their resources within their systems. It also explains the desire of MNEs to create options and flexibility so that they can respond to various economic stimuli internationally. In addition, it offers important insights into transfer pricing and market fragmentation.

One of the benefits to be derived from MNE internal control systems is the ability to set prices for transactions or to allocate costs within the system without reference to prevailing prices or cost structures. However, the MNE system represents market fragmentation. Each individual MNE constitutes a separate internal market with very little or no integration with others within the same industry. Thus, an industry in a host country, such as the aluminum industry in Ghana, could be fragmented along oligopolistic lines and yet would be connected in an undesirable way with other countries within the MNE system. The internal operational dynamism of MNEs explains the concerns of several home and host countries over the effects of MNEs’ activities on national economic policies and development. Therefore, several questions arise as to the appropriate host country policies towards FDI.

An important factor in determining the possible policy prescriptions of the internalization theory is the issue of costs and benefits. Specifically, how are the costs and benefits from MNE operations distributed? According to the theory there are two types of costs and benefits involved

\textsuperscript{177} See Rugman, supra note 161, at 371-75.
in internalization: 1) private costs and benefits relating to the firm,\(^{178}\) and 2) social costs and benefits relating to the national welfare implications of MNE operations.\(^{179}\) FDI takes place when the benefits to the MNE outweigh the costs.

The fact that it is beneficial for the MNE to internalize does not necessarily mean that the host country or society at large benefits from the operations of the MNE. The operational costs of MNEs might understate the social costs. Therefore, the private benefits might exceed the social benefits. In an explanation of the policy implications of the MNE, Mark Casson suggests that, in several areas, MNEs might be benefiting more than host governments since the private benefits exceed the social benefits.\(^{180}\) In this respect Casson made the startling assertion that there might be too much FDI in the world.\(^{181}\) In his view, that MNEs benefit more than governments from internalizing their operations implies that there could have been more arms-length licensing arrangements, presumably between MNEs and local licensees. In fact, he suggests that host governments should improve the external market environment to make licensing easier by providing better protection to owners of technology.\(^{182}\)

Taken to its logical conclusion, the argument advanced above suggests that host governments should not encourage FDI. In fact, they should discourage it. Any incentives that would increase internalization would be misplaced on the basis of the current costs and benefits involved. However, an incentive policy depends upon the validity of the assertion that there might be too much FDI. It has been shown that very little of the FDI goes to the poorest of the developing countries. Even among the richer of the developing countries there is a concentration of FDI in the richest of them. Taken as a whole, the developing countries have continued to attract only a small fraction of the FDI in the world, accounting on the average for only one-third of the total flows of FDI between 1960 and 1979.\(^{183}\) Therefore, it is doubtful whether, as a general statement, Casson’s suggestion is applicable to several developing coun-

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\(^{178}\) See generally J. DUNNING, INT’L PROD., supra note 37; P. BUCKLEY & M. CASSON, supra note 35; M. CASSON, supra note 65; Giddy, supra note 176. See also Garnier, Context and Decision Making Autonomy in Foreign Affiliates of U.S. Multinational Corporations, 25 ACAD. MGMT. J. 893 (1982) (an interesting article that bears on the internalization theory).

\(^{179}\) See J. DUNNING, INT’L PROD., supra note 37, at 33.

\(^{180}\) M. CASSON, supra note 65, at 83.

\(^{181}\) Id. at 84.

\(^{182}\) Id. at 85.

\(^{183}\) Id. at 50, 89-91.
tries. What Casson has uncovered is a distribution problem not unique to FDI.

These countries seem to recognize the distribution problem and the need for improved relations in arms-length technology transfer transactions. Yet it is doubtful whether the distribution problem is an outgrowth of the insufficient number of licensing contracts. It might also be explainable by the industrial traits and the general environment of the MNE. Increasing the number of licensing contracts might have very little practical utility to host countries without the necessary local entrepreneurial group to engage in licensing operations. Moreover, there is an implicit assumption that licensing will improve the host country’s tax revenue picture. This does not follow. Any increased protection to industrial property as suggested by Casson might increase the market imperfections and the disparities in bargaining power between licensors and licensees, thereby encouraging oppressive terms. For several host developing countries, the question still remains as to how to entice and channel sufficient amounts of FDI for their economic development.

1. **Tax Incentive Policy Implications**

   It is useful to examine the nature of the conditions for FDI to see whether they are susceptible to inducement policies. It should be noted that the policy discussion of the intangible assets hypothesis and the industrial organization theories are relevant since they also relate to the same market imperfections discussed here. The internalization theory draws a distinction between two market imperfections that explain FDI—those that are germane to market failure and those that are induced by government policies. Government-induced imperfections would include tariff barriers, tax rate differentials, and exchange restrictions. If either or both of these sets of imperfections exist, the necessary incentive for FDI operations will exist.

   It is, once again, possible to have redundancy and costly tax incentive policies. If market failure exists, then the government-induced imperfections need not be generated. If market failure does not exist, then tariff and non-tariff barriers might provide the necessary incentive for defensive investments, thereby making tax incentives redundant under those circumstances.\(^{184}\) The theory also asserts that the world is imperfect and that the information markets are almost always imperfect, thereby suggesting that the necessary conditions for FDI exist through

\(^{184}\) See generally Horst, *Optimal Behavior*, supra note 32; Mundell, *supra* note 91.
the malfunctioning of the markets. Hence, host governments need not generate more imperfections, particularly in the form of tax incentives.

The argument against government-induced market imperfections is even stronger given that they generally tend to increase the social costs of FDI which might not be compensated for in the distribution of MNE generated wealth. The efficacy of tax incentives might be in doubt for other reasons. One of the main arguments of the internalization theory is the possibility that the MNE may engage in market fragmentation whereby it closes its internal markets to outsiders. Through this process, it can erect some barriers to entry and engage in transfer pricing to take advantage of tax rate differentials between countries. The importance of transfer pricing as an incentive for sourcing investments in several industrializing countries cannot be doubted from the previous discussion of the MNE system. The extent to which this will continue to be an incentive for FDI will depend on the response of host countries to transfer pricing.

There appears to be greater host country awareness of the problems of transfer pricing and the need to control intra-firm transactions. Several countries have sought to regulate such transactions in technology transfer and other commodities trade. However, the efficacy (but not the desirability) of such regulations is in doubt. Mark Casson suggests that one of the best policies towards redressing the distribution problem in FDI requires tightening up host countries' regulations on transfer pricing so as to close all loopholes and effectively enforce the regulations. This would eliminate tax differentials and price manipulation as an incentive for FDI. It would also increase the social benefits to the host country.

With better host country accounting controls and better information on prices and costing practices, the efficacy of tax incentives as an encouragement for related party transactions is very doubtful. This is particularly so in industrialized countries. Even in the case of developing countries, the sensitivity of host governments to accounting malpractices is such that transfer pricing will most likely not continue be a very strong incentive in the FDI process.

2. Control as an Incentive

Although tax incentives might not appeal to the policy analyst under this theory, other policy instruments are available. First among these is the issue of control. Like the industrial organization theory, in-
ternalization centers around the desire to control the operations of the firms. As explained earlier, if the basic conditions for internalization generally exist, then the question is whether host governments should permit and encourage ownership structures that would place the locus of control both *de jure* or *de facto* in the MNE. An extensive analysis of the issue of control as a possible incentive policy under the industrial organization theory has already been developed. Several of the arguments advanced there are equally applicable here. However, one should note the difference between the two theories. The industrial organization theory raises several questions about economic distortions, the loss of policy autonomy, or denationalization that might arise from MNE control over FDI. The internalization theory seems to associate MNE control with efficiency. Therefore, it fails to recognize several of the problems inherent in the political economy of the MNE and FDI. Under this theory, internalization raises only distribution problems, not issues relating to the path of industrialization. Internalization does not even raise questions about the choice of technique as a related question of ownership and control. Thus, for the host governments, control over operations is not as important as controlling prices within the internal markets to eliminate transfer pricing and market fragmentation.

The implication is that foreign ownership legislation could be an incentive for FDI. Local ownership and control is not essential as long as foreign ownership and control is accompanied by the appropriate policies resulting in distributive equities in the private sector and social benefits from FDI. Though this argument is similar to others advanced under the industrial organization theory, it should be stressed that price-related solutions alone cannot correct the problems of market fragmentation and inappropriate technology. First, the host government policies should include prescribed technology and local content requirements for various FDI activities particularly in manufacturing. This type of policy would tend to generate the use of appropriate technology and the necessary intersectoral linkages. Then, policies controlling intra-firm prices would ensure that the internal markets of the MNE are open and the prices of their transactions with third parties are fair. Hence, there would be a policy of encouraging FDI through foreign ownership and control statutes, but ensuring that such ownership and control does not result in monopoly profits, manipulation of host countries, or denationalization.

3. Other Policy Implications

Besides the issue of control, there are other possible policy instruments relating to costs associated with the political environment in the
host country. Internalization may involve costs associated with host
government’s discriminatory practices against foreign firms. It may also
involve costs related to political instability and uncertainty. These may,
in turn, induce the firm to underinvest in the collection of information
about the host country’s environment, making investment decisions diffi-
cult. It might even involve costs related to the regulatory functions of
the host government.

Under these circumstances, it is possible to introduce policies to en-
courage FDI subject to the issue of distribution. For example, the host
country might reduce or eliminate any discriminatory practices against
foreign firms. It may also eliminate irrelevant regulatory functions and
adopt the appropriate policies towards controllable political instability.
The host government might even subsidize the search costs involved in
FDI by investing in information gathering and dissemination. Though
these cost reduction policies alone will not act as incentives for internal-
ization, they are nevertheless important in the internalization calculus.
Together with the MNE-related costs, they constitute sufficient, but not
necessary, conditions for internalization. Here again cost-related policies
re-emerge as possible incentive instruments, as opposed to the current
emphasis on tax reductions.

Finally, of crucial importance to the internalization theory is the
foreign economic policies of a host country. The MNE, according to this
theory, thrives on a market environment that permits the MNE’s func-
tional dynamism and its ability to shuttle resources between various
points within its system. This suggests quite strongly that a host country
bent on attracting FDI must adapt its foreign economic policies to re-
spond to these factors. To create the appropriate business and economic
environment for FDI, its economic policies must include free trade and
free enterprise. Nonetheless, since the theory was designed for an imper-
fect world, the least that would be required of a host country is a specific
policy that permits the MNE to engage in its distinctive behavior even if
the general policy is one of restriction.

VI. CONCLUSION

Although tax incentives have remained significant policy instru-
ments for attracting FDI, they have been largely ineffective. It was the
objective of this article to develop alternative policies for encouraging
FDI based upon different theories of the MNE. Such a task could not be
carried without a thorough understanding of the MNE.

If functional dynamism, operational flexibility, and a “foot-loose”
mentality in the use of its financial, human, technological, and other re-
sources are the hallmarks of the distinctive behavior and characteristic attributes of the MNE, then a host country determined to attract significant amounts of MNE investments must first develop a sophisticated understanding of the MNE system. This understanding will permit host countries to develop a more comprehensive and consistent policy towards the MNE and its investments. This is of fundamental importance when one considers that the MNE can sometimes evoke an adverse reaction even among those who seek to entice FDI.

Consistent and meaningful policies require, in addition, some theoretical basis. In the past, various theories of the MNE were canvassed as alternative and competing explanations of the MNE and the FDI process. This article has explored two such theories: the intangible assets hypothesis and the industrial organization theory. What is interesting about them is their similarity. For a host country trying to develop effective policies for attracting FDI, it is neither desirable nor advisable to treat theories of the MNE as alternatives. As suggested by the internationalization theory, an eclectic approach is required. The MNE and its environment constitute a very complex phenomenon requiring such an eclectic approach for the development of appropriate host country's policies. For these reasons, the policy prescriptions canvassed in this article should be seen as complementary to each other.

Three major areas of incentive policies were explored in this article: technology, labor, and ownership and control. Since FDI generally constitutes a bundle of resources, capital, technology, and labor, an effective way to develop policies for encouraging FDI is to evolve separate but complementary policies towards each component of the FDI bundle of resources. One such policy would relate to the technology that enters the MNE system. The technology chosen by the MNE for a particular FDI might well suit the needs for the MNE's system but not those of the host country. The technology and its products might be inappropriate not because of the level of development of the host country, but because they do not fit into the host country's industrial policies nor foster certain policy objectives in either the short or long run. Thus, given certain host country industrialization policies, some specific technology transfer incentive policies can be adopted to ensure the appropriate technology in FDI. Suppose the host country is determined to develop a complex industry, that would require complex technology and the appropriate corresponding technology transfer policy. The host country may subsidize the cost of the required complex technology. It may subsidize the training of the required skilled local labor for such technology or encourage the efficiency of labor. It may also stabilize the rental rates for technol-
ogy transfer. To encourage local adaptation, R & D and the development of significant local capability in a particular industry, the host country may subsidize R & D and technology that fits the adaptation needs through direct grants. It may also subsidize and actively participate in the training of researchers. In the medium- and long-term, these incentives could have a significant and positive impact on attracting FDI.

Though the host country can encourage the use of the appropriate MNE-owned technology in the FDI process, there appears to be even a more fundamental policy for technology. Since FDI generally involves the use of MNE-owned technology developed through R & D, it should be possible for host countries to influence the initial development of specific appropriate technology. This could be achieved through joint research ventures between MNEs and host governments. It could involve just one MNE and a host government, or several MNEs and several host countries with similar technology and FDI needs. The rights of the parties and the form of host country involvement would all be a matter of contract.

Given the technology input policies, the host government can then develop other complementary labor policies to enhance its total incentive package. It is generally believed that cheap labor policies are required to entice FDI. However, the evidence seems to suggest that the efficacy of cheap labor policies might depend on several factors including, in particular, the skills and efficiency of labor. Therefore, the appropriate labor policies for attracting FDI must be task directed. Various industries require various forms of labor input. Since the approach examined here calls for industry-specific policies within a coherent general industrial policy, different labor policies might be appropriate for various industries. For instance, labor policies may be directed at labor costs, its efficiency, the acquisition of skills, or any other factor depending upon the industry, the labor situation, and the host government's objectives. Whatever policies are adopted, the host country should be sensitive to and develop complementary policies to address the issue of distributive equities and ensure that the burden of industrialization is not borne by labor alone.

Ownership and control over foreign operations, some theories have stressed, go to the very root of the motivation of the MNEs to invest abroad. If that is the case, then logic demands that any policy designed to entice the MNE to invest abroad must address the question of ownership and control within the context of a host country's industrial policy, its level of technical competence, and the strategic objectives of MNEs. The question of who owns and manages the resources in a particular
industry might be irrelevant, important, or even crucial to the attainment of certain host country's objectives. On the other hand, ownership and control might be crucial to the MNE for a specific FDI or an aspect of it, but not for other types of FDI. A blanket policy approach could lump together all forms of FDI under the same ownership and control policies. However, that is likely to be ineffective. An approach that recognizes the need for discriminatory policies towards the issue of ownership and control is required. Ownership and control could be used as incentives for FDI where they are crucial to either or both the host country and the MNE. The MNE has over the years demonstrated a remarkable adaptability to its environment. Ownership and control policies that are sufficiently responsible to the MNE environment, its strategic goals, and combined with well-established international contract forms such as joint ventures, production sharing agreements, service contracts, and fade-out agreements, might be an effective way to entice FDI. For several host countries, new and more dynamic arrangements could be even more effective in enticing FDI. However, given the political economy of the MNE and its tendency to fragment markets, the ownership and control policies, should, when appropriate, include local content and intra-firm pricing policies to minimize the negative impact of the MNE system on distribution and intersectoral linkages.

In addition to these policy options, host countries may consider information gathering and dissemination on FDI opportunities. They may consider subsidizing research costs, improving controllable political risks, and providing an adequate regime of industrial property protection and enforcement.

Finally, it is important to note that the mere passage of incentive statutes is hardly sufficient to encourage significant amounts of FDI. Apart from such laws and policies being coherent and task-oriented, an active participation of the host government is important. Whatever the host country does, it should keep in mind the nature of the MNE system. It must also understand the characteristic attributes of the MNE, its politico-economic implications, and the subsequent reaction that the MNE sometimes evokes. It would appear that the more permissive the host country's economic environment is, the better the climate for FDI. Even where the host country is involved in an active management of its economy, specific policies could still create the appropriate climate for FDI.